103

UNINSURED BANK PRODUCTS: RISKY BUSINESS FOR SENIORS?

(103–861)

Y 4. AG 4: 103-23

Uninsured Bank Products: Risky Busi...

HEARING

BEFORE THE

SPECIAL COMMITTEE ON AGING
UNITED STATES SENATE

ONE HUNDRED THIRD CONGRESS

SECOND SESSION

WASHINGTON, DC

SEPTEMBER 29, 1994

Serial No. 103–23

Printed for the use of the Special Committee on Aging

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UNINSURED BANK PRODUCTS: RISKY BUSINESS FOR SENIORS?

THURSDAY, SEPTEMBER 29, 1994

U.S. SENATE,
SPECIAL COMMITTEE ON AGING,
Washington, DC.

The Committee met, pursuant to notice, at 9:35 a.m. in room 628, Dirksen Senate Office Building, Hon. David Pryor (Chairman of the Committee) presiding.

Present: Senators Pryor, Reid, Feingold, Cohen, Burns, and Riegle.

Also present: Theresa Forster, staff director; Kenneth Cohen, investigator; Mary Berry Gerwin, minority staff director; Helen M. Albert, minority investigator; Chip Cannon, legislative fellow; and Allison LaRocca, legislative correspondent.

OPENING STATEMENT OF SENATOR DAVID PRYOR, CHAIRMAN

Senator PRYOR. Good morning, ladies and gentlemen. The hearing will come to order at this time.

We especially want to welcome all of you today. We want to welcome our guests who will serve on our two panels this morning. We have panel 1 all assembled here, ready for us.

I want to take this opportunity to greet my colleague, Senator Bill Cohen of Maine. We have worked very closely on preparation of this hearing, as we have on all the hearings that we have chaired during the course of the 103d Congress. Senator Cohen is a delight to work with. He is committed to these issues, and I want to sincerely thank him at this time. This is truly one of those nonpartisan committees of the U.S. Senate. If you questioned whether such a committee actually existed, it does exist in the Special Committee on Aging. I want to thank Senator Cohen.

This morning we're going to be talking about "Uninsured Bank Products: Risky Business for Seniors?," and it is a culmination of several months of investigation by the Special Committee on Aging staff. The results of our investigation raise very serious concerns about bank sales of uninsured products to older Americans.

The information that has been collected and will be presented this morning by the Committee suggests that some banks and some brokerage subsidiaries are using sales practices which encourage older Americans and other Americans to take their money out of insured investments, like savings accounts, CD's, and others, and put them in uninsured securities markets, regardless of the appropriateness of such investment moves. An alarming number of seniors believe that their principals are insured, where in fact they are

not. Elderly people may stand to lose some, if not all, of their savings on uninsured investments.

We have obtained from the FDIC and from the Securities Exchange Commission just a sample of many letters they have received from consumers. I may from time to time quote from some of these letters that have been filed with the FDIC and the SEC.

Just yesterday we had some good news: Federal banking regulators announced that bank employees who sell mutual funds but are not registered brokers will have to pass the same test that other stock brokers take. We're going to ask some of our witnesses about this this morning.

We also note that Aging Committee staff interviewed dozens of current and former brokers of large multi-State banks and elderly bank customers and have reviewed internal bank documents. Based on this study, it does appear that the policies of some banks place the security of many older bank customers at risk, regardless of the customer's background or the income level.

We are not bank bashing today, but we are raising some concerns about some questionable sales practices and the lack of sharing of real information or the facts by brokerage employees with the customers. Some of these brokerage employees, I should say, are in the bank and they're not actually employees of the bank. It is very confusing and, we think, very questionable, indeed.

We also will be talking about a typical situation. We have a chart over here to our right, the Committee's right, and this is a customer's CD account history. This was forwarded from a teller to a broker, and the teller wrote in the printout, "David, see what you can do." This is what the teller writes to the broker. The broker, we are told, then used this information to decide who to contact about buying a mutual fund or another uninsured product. These tellers and customer service representatives that we will hear from today receive some sort of a reward or a commission or a bounty for referring their customers to brokers.

Friend, See What You Can Do! Dollar 12

Thankyou,

```
X61505MA                 ACDT 1 CIS        DDA ACCOUNT DETAIL        94/03/17 14.30.22
CUPR        CO     21 OP TJ40                MS 64000 ACTION SUCCESSFUL
ACTION  INQ  (ACPR,ACBC)          COID    22  PRODUCT DDA   ACCOUNT

NAME                                   PERSONAL MONEY MARKET                  MAX MMIA
                              ***   BALANCE INFO    ***     ***    HISTORY INFO    ***
STATUS 04- INACTIVE           EFFECTIVE AS OF 94/03/17      AV CTD CUR       133,749.93
OPEN DATE  89/11/14           AVL BAL          133,749.93   AV CTD COL       133,749.93
CLOSE DATE                    BOOK BAL         133,749.93   AV 3M BAL        133,319.28
CYCLE CODE          14        COL BAL          133,749.93   AV 12M BAL       132,084.84
OFFICER            020        LAST DEP DATE     09/11/14    INT ERND YTD         536.46
BRANCH             020        LAST DEP         109,451.59   INT PD LST CYCLE     247.69
DEPOSIT HOLD IND   C          INT CTD              225.98   INT PD LST YR      3,344.27
NO CKM OR PC                  LAST STMT DATE   94/02/18     OD INFO          000/000/000
CARD STATUS CD                STMT BAL         133,749.93   SV CHG LST CYCLE         .00
SERV CHG CD     86            CKM PAID INTO OD        NO    ***  WITHHOLDING INFO  ***
LINKED ACCTS:                   NONE                        CURRENT YR               0.00
***    RELATED ACCOUNT BALANCES    ***                      LAST YEAR                0.00
AGG CD PR CYCLE                        .00
TDA MIN BAL PR CY                      .00                  LINE OF CREDIT          NO
TDA AVG BAL PR CY                      .00                  CASH MGMT ACCT          NO
AGG IL PR CYCLE                        .00                  WITHHOLDING CODE        00
MMI MIN BAL CURR CY                    .00
ADDITIONAL INQUIRY SCREENS: LOC (    )
```

POB stand off

She came in today and wasn't sure what she should do with her money!

In this case, this was a teller who saw that an elderly person's CD had matured or they had some extra money on hand, and they immediately contacted David, who was the broker, and said, "This person has some extra money. See if you can get them to move that money into a certain account," and I think a commission was paid to the teller for having this transaction take place.

The investigation, I think, also suggests that what appears to be happening is that some banks are putting their needs before those of their customers. In other words, instead of deciding what's best for the customer, they're deciding now in many cases what is best for the bank. So we think disclosure has got to be forthcoming.

Finally, let me say that many senior citizens have relied on earnings from their savings to cover day-to-day expenses, and when they walk into a bank or into a bank lobby or into the institutional setting of a financial institution such as a bank in their hometown or neighborhood which they have trusted and done business with and they see that seal on the door or on the window "Deposits insured by the FDIC," the potential customer also believes that whatever transaction is going to take place in the bank, is backed up by that bank and insured by the Federal Government.

Too often—too often—when a customer or a potential customer walks in that bank looking, for example, for a higher rate of interest or a better return on their investment, they receive very small boilerplate language. This language might indicate, such as this brochure to our right that the product is not backed by the FDIC. This particular bank made a brochure, and I think a lot of banks do, that it is hardly recognizable or readable. It confuses the fact that the mutual funds that the bank is trying to promote are not actually insured nor guaranteed by the Federal Government. We think that full disclosure should be had and should prevail, and we're certainly not seeing it now.

☑ **Yes,** I'm interested in making the most of my money, and avoiding the runaround of dealing with everyone, everywhere. I understand this consultation is free and there's no obligation to purchase anything.

Name _____

Telephone _____

Branch _____

Best time to call: ____ a.m. ____ p.m.

Financial Services
1-800-759-

Not bank insured or guaranteed by Bank and are not insured by the FDIC
Investment Corporation Member SIPC Insurance Services, Inc.
Trust Company *is a registered service mark of Banking Corporation
11/92 SFS 2 360 (8/88) (50/90)

When you need a broker, financial advisor, insurance agent, or trust officer, call me.

Your ____ Investment Specialist
1-800-759-____

Financial Services

We're going to have some tremendous witnesses. Once again, we thank those witnesses. I'm going to submit my full statement for the record and at this time yield to my colleague and friend, Senator Cohen.

[The prepared statement of Senator Pryor, along with Senator Simpson's prepared statement, follows:]

PREPARED STATEMENT OF SENATOR DAVID PRYOR

Good morning, ladies and gentlemen. I want to welcome all of you here this morning, and want to extend a special thanks to all of our witnesses who are here today. I also want to recognize the efforts of my colleague from Maine, Senator Cohen, who has had significant involvement in our inquiries into this important issue.

Today's hearing will focus on bank sales of uninsured products, such as mutual funds, to older Americans. Our interest in financial issues as they impact the elderly is not new. Last year, for example, the Committee held a hearing on fraud in the retirement planning industry.

This hearing, entitled "Uninsured Bank Products: Risky Business for Seniors?" is the culmination of an investigation conducted by Aging Committee staff. The results of our investigation raise serious concerns about bank sales of uninsured products to older Americans.

The information collected by Committee staff suggests that some banks and their brokerage subsidiaries are using sales practices which encourage older Americans to take their money out of insured investments like savings accounts and certificates of deposit and put it into the uninsured securities market, regardless of the appropriateness of such investment moves. An alarming number of seniors are led to believe that their principals are insured, when in fact, they are not. Elderly people may stand to lose some, if not all, of their savings on uninsured investments.

Let me say that I am heartened by the recent interest in this area by federal regulators. Just yesterday, federal banking regulators announced that bank employees who sell mutual funds, but are not registered brokers, will have to pass the same tests that other stockbrokers take.

However, it seems clear that additional steps might need to be taken. Despite the fact that earlier this year federal banking regulators established guidelines for bank sales of uninsured products, there are still problems.

Aging Committee staff interviewed dozens of current and former brokers of large multi-state banks and elderly bank customers and have reviewed internal bank documents. Based on this study, it appears that the policies of some banks place the security of many older bank customers at risk, regardless of the customers' background or income level. This threat comes at a most inappropriate time of life, as many elderly are on fixed income and must rely on their savings to help finance housing, medication, and food.

An example of one alleged deceptive sales practice is the sharing of confidential customer bank information with brokerage employees, without the knowledge of the customers. Staff have heard allegations that banks share information such as customers' mortgage applications and CD account history printouts with bank brokers.

For example, this customer's CD account history, was forwarded from a teller to a broker. The teller wrote on the printout "David, see what you can do." The brokers, we are told, then use this information to decide who to contact about buying a mutual fund or other uninsured product. These tellers and customer service representatives, we will hear today, receive some sort of reward or bounty for referring their customers to brokers.

Our investigation suggests that what appears to be happening is that some banks are putting their needs before those of their customers. Instead of deciding what is suitable for the customer, some banks are instead deciding what is suitable for the bank.

It should be emphasized that the intent of this hearing is not to bash banks. I am not suggesting, and I don't think that any of my colleagues would, that all banks actively seek to convince senior citizens to invest their retirement savings in shaky securities. Nor do I believe that banks should get out of the securities business.

However, it must be noted that banks are not just any business. Banks are one of the community's most trusted institutions. For decades, the Government has assured our Nation's citizens that bank accounts are perfectly safe holding places for money. Some might argue that banks are trying to capitalize on that tradition of trust as they move into the uninsured-product business.

Historically, many seniors have relied on earnings from their savings to cover day-to-day expenses; however, relatively low interest rates on conventional bank

products are setting consumers off in search of higher rates of return. When it comes to uninsured products such as mutual funds, some seniors are first-time buyers and are thus unaware that purchasing uninsured products could result in devastating financial losses.

Many of the problems we will hear about today seem to be related to seniors' perceptions of banks. Many people—seniors included—think that all investments made at their local bank are insured by the Federal Deposit Insurance Corporation (FDIC). While products such as savings accounts, checking accounts, and certificates of deposit are insured by the FDIC, other products increasingly being sold by banks are not.

At today's hearing, we will hear allegations that some marketing practices further blur the distinction between insured and uninsured products that are confusingly similar to the names and the distinctive color schemes used to market traditional insured bank products. In addition, some banks relay the fact that their uninsured products are not FDIC insured through perfunctory, lawyerly, disclosures. These and other practices we will hear about today, if true, violate guidelines of federal banking regulators as well as voluntary industry guidelines.

The primary questions that our hearing will try to answer are:

Are banks doing enough to make sure that seniors understand the risks associated with uninsured products and to ensure that they are recommending appropriate investments based on an individual's financial and age status?

To what extent are banks employing sales practices which steer unsophisticated savers from insured investments toward riskers ones?

What role can the federal government play to protect consumers who buy uninsured products in the bank setting?

I am hopeful that, through the testimony of our witnesses today, we'll get a clearer picture of what is going on in this important area.

Prepared Statement by Senator Alan K. Simpson

I want to thank our Committee Chairmen and my fine old friends, Senator Pryor and Senator Cohen, for bringing this important issue of uninsured bank products before the Aging Committee this morning. This is an issue that is not only of interest to seniors but to people of all ages who are looking for investment opportunities. Unfortunately, seniors have the most to lose if they place their earnings in investments that are of "high risk," including mutual funds and some types of Government bonds, because they are often the ones who can least afford to lose money on a bad investment. The elderly who have managed to put away some portion of their earnings in savings accounts and certificates of deposit during their working years are most at risk. Many of those seniors are most likely first-time investors who are not fully educated about the high risks involved in purchasing uninsured bank products such as mutual funds. This threat of losing some or all of their life savings comes at a time in life when seniors must rely solely on their savings to help finance their housing, health care needs including medication, and food.

I was sadly surprised to learn about the deceptive sales practices that some banks have been accused of practicing including the marketing of these products. It is clear why banks have turned to these investments. With interest rates dropping to low levels, banks have had to develop new products and services to retain and attract customers. Some banks have also further blurred the lines between insured and uninsured products in their marketing practices by using the same types of brochures and materials to market these products. In addition, I understand that the fees and commissions resulting from the sale of mutual funds and related investments are in many cases greater than what banks can earn from loans. What an incentive for a bank associate to push the sale of investment funds. I am quite interested in hearing from our broker and customer witnesses to learn in more detail about these marketing and sales practices first-hand.

Finally, I know that we are not here today to engage in a debate between the banking industry and the securities industry concerning which entity best serves seniors and their investments. What is important to get out of this hearing is the fact that seniors need to be better educated about their investment options, especially as they grow older and need ready access to their moneys. Above all, it is important for us in the Congress to examine and push for better disclosure requirements for these products within the banking industry. Banks should be required to make it clearly known that mutual funds and other high risk investments are not insured by the Federal Government. These types of disclosures should be prominently displayed in the bank's promotional materials and product displays. Bank employees should be required to make this type of disclosure orally to customers to make sure that customers understand that what they are purchasing is a high-risk

investment and that it is not insured by FDIC. A customer must fully understand that if he loses money on a high risk investment, he will not be protected by the Federal Government.

This type of disclosure would go a long way toward educating seniors—and indeed, customers of all ages on the advantages and disadvantages of various investment options—and would make people much more aware of which investments involved higher risks.

I again want to commend my fine colleagues, Senator Pryor and Senator Cohen, and their staffs for the fine work on this hearing we pursue today. I look forward to hearing the testimony of our witnesses.

STATEMENT OF SENATOR WILLIAM S. COHEN

Senator COHEN. Thank you, Mr. Chairman, and let me thank you especially for your kind remarks about the working relationship we have. It's one that I certainly enjoy, and I'm not sure you find it in any other committee in the Senate and perhaps not the entire Congress itself.

As you've indicated, this is not a hearing designed to indict the banking industry. I think it's very understandable that banks, because of the low interest rates that are now paid on CD's and savings accounts, are trying to increase or maximize their opportunities as well, and we're not indicting them for doing that.

But there is also a good deal of evidence that there's great confusion out in the hinterlands. The average person is confused about exactly what he or she is getting into, and some banks, according to the information we have, are exploiting this confusion. They're preying upon the confusion, and in some cases, bank tellers are allegedly cold calling customers whose CD's are about to mature or peddling securities without full information. We've had allegations to that effect. Or that bank employees are giving the brokers the names and bank account information of customers who have made large deposits in exchange for referral fees. Or banks giving high commissions and trips or other incentives to brokers who sell the bank's own mutual funds, regardless of whether it is a suitable investment for the customer. Or banks giving confusing and misleading information to customers about the safety of the investments being sold on the bank premises, and, of particular concern to this Committee, is that some banks aggressively target elderly customers to purchase uninsured investments without fully disclosing the risks involved.

I might point out that there's a corresponding obligation on the part of the purchaser. Senator Pryor and I have had other hearings in which we have, time after time, tried to alert the senior citizen population that they have an obligation to make themselves informed, that they should be educated about practices, that they should follow the old Latin axiom of "caveat emptor." If something appears to be too good to believe, it usually is too good to believe. So we have a corresponding obligation on the part of those who are seeking to make these investments.

But just as the consumers have to take responsibility for their investment decisions, banks and brokers must not be allowed to play hide-and-seek with their customers when marketing these uninsured instruments. Hiding disclosure signs behind potted plants in bank lobbies, writing disclosures, as the Chairman has mentioned, in microscopic fine print, or engaging in other practices that

are designed to confuse or even potentially mislead their customers simply cannot be tolerated.

There are just a couple of observations I want to make before we begin the hearing. First, we have to take steps to clarify who's responsible for monitoring banks that market securities and close any regulatory gaps that currently exist in the enforcement and oversight of these marketing practices. Such gaps currently exist.

Second, as I've indicated, this is not the first time we've seen allegations of misleading or overreaching practices in the sale of securities and mutual funds to senior citizens. Last year my staff on this Committee conducted an investigation of mutual fund salesmen who specialized in peddling high-risk, inappropriate mutual fund investments to unsuspecting senior citizens, and it appears that some banks are now being implicated in similar schemes that could spell financial ruin for some senior customers.

So I am working on legislation to address these practices that the Committee's earlier investigation revealed. I look forward to working with the Chairman and other members of the Committee to better guard against what I would call fraudulent and abusive practices in the marketing of securities, particularly to older people living on fixed incomes.

Again, to make it very clear, not all banks are doing this, and there's responsibility on the part of the investor and the purchaser, but we are determined to see to it that banks, or employees of banks, who are engaging in potentially unscrupulous practices have to be stopped, and we will take whatever measures we can to achieve that end.

Thank you, Mr. Chairman.

[The prepared statement of Senator Cohen follows:]

PREPARED STATEMENT OF SENATOR WILLIAM S. COHEN

Mr. Chairman, I commend you for holding this hearing on questionable marketing practices of some banks that sell uninsured investments, such as mutual funds, annuities, and stocks to older Americans.

As you have pointed out, the committee staff's investigation has revealed disturbing evidence that some bank employees, at times with the blessing of the banks themselves, are using deceptive and misleading sales practices to market uninsured, risky, or inappropriate investments to their customers.

As yields from savings accounts, certificates of deposit, and other traditional savings vehicles plummeted due to record low interest rates, we have witnessed a stampede of banks into the lucrative mutual fund market. Not surprisingly, banks are desperately trying to keep their customers from pulling money out of their institutions by offering alternatives to CD's or other insured savings accounts.

While we should not close the door to banks wanting to sell securities, we must recognize the special dangers and problems that this trend in banking presents—namely, that there is a tremendous potential for confusion by bank customers about the safety and nature of the investments they are buying. Surveys have shown that the vast majority of bank customers are unaware that mutual funds, stocks, and annuities sold at their banks are not insured by the FDIC, or pose any financial risk at all.

Unfortunately, the committee's investigation reveals that some banks are playing on this confusion of its customers and steering unsuspecting customers toward risky investments. The alleged practices of some banks are very troubling, such as:

Bank tellers "cold-calling" customers whose CD's are about to mature and peddling annuities under false pretenses;

Bank employees giving to brokers the names and bank account information of customers who have made large bank deposits in exchange for referral fees;

Banks giving high commissions, trips, or other incentives to brokers who sell the bank's own mutual funds, regardless of whether they are suitable investments for the customer;

Banks giving confusing and misleading information to customers about the safety of investments being sold on banks premises;

And, of particular concern to this committee:

Some banks aggressively targeting elderly customers to purchase uninsured investments without fully disclosing the risks involved.

Mr. Chairman, you and I have repeatedly stressed in this committee's series of hearings on scams against the elderly that senior citizens—and all consumers—must ask questions and make informed decisions when they are offered deals that are too good to be true or are given a hard sales pitch.

Just as consumers must take responsibility for their investment decisions, however, banks and brokers must not be allowed to play "hide the ball" with their customers when marketing uninsured investments. Hiding disclosure signs behind potted plants in their bank lobbies, writing disclosures in microscopic fine print, or engaging in other practices designed to confuse or mislead their customers should not be tolerated.

There are a few observations I would make as we turn to this important testimony today:

First, we must take steps to clarify who is responsible for monitoring banks that market securities and close any regulatory gaps that exist in the enforcement and oversight of marketing practices.

Second, unfortunately, this is not the first time we have seen misleading, overreaching practices in the sale of securities and mutual funds to senior citizens. Last year, my staff on this committee conducted an investigation of mutual fund brokers who specialized in peddling high risk, inappropriate mutual fund investments to unsuspecting senior citizens. It appears that banks are now getting involved in these schemes that could spell financial ruin for some senior citizens.

I am now working on legislation to address the practices that this committee's earlier investigation revealed, and I look forward to continuing to work with you, Mr. Chairman, on ways to better guard against fradulent and abusive practices in the marketing of securities, particularly to older Americans living on fixed incomes.

Senator PRYOR. Good. Thank you, Senator Cohen.

Senator Feingold.

STATEMENT OF SENATOR RUSSELL D. FEINGOLD

Senator FEINGOLD. I'd like to thank the Chair and the ranking member also for calling today's Aging Committee hearing to explore problems seniors face with uninsured bank products. As has consistently been the case under the leadership of this chairman, this committee has identified an important issue, and as I've indicated a number of times, I chaired the Wisconsin State Senate Aging Committee for 10 years in the State senate, and I also chaired the Banking Committee for 10 years, so this is sort of an ideal hearing in terms of my interest.

I regret that I do have votes in another committee at 10 and apologize to the witnesses that I have to tend to that, but I will be reading the materials.

Mr. Chairman, I feel that this is a perfect example of why this committee is needed, and it's so fortunate that this committee withstood an effort last year to potentially eliminate the committee. I especially look forward to hearing the testimony from the folks from Florida who came all the way up here to tell about their experiences, and I want to assure you, based on my observations of the chairman's efforts, that your time won't be wasted.

I also would mention just for a second that we just passed a new interstate banking bill, which, frankly, I voted against because of some concerns about the structure of the banking industry, and I think for that reason as well, at a time of great changes in the banking industry as a whole, this hearing and its topic are very timely.

I thank the Chair.

Senator PRYOR. Senator Reid, we're proud to have you this morning and look forward to your statement.

Thank you for your statement, Senator Feingold.

STATEMENT OF SENATOR HARRY REID

Senator REID. Thank you very much, Mr. Chairman. It's interesting that the youngest Member of the Senate has been the strongest advocate that we've had in many, many years for issues relating to seniors, and that's based upon his experience in the Wisconsin Senate. I know during the debate on health care, there was no one that was more concerned about long-term care than Senator Feingold, and we all learned a lot from him during that debate, and next year when we move into health care, I'm sure that that's something that will still be on your mind, and it will force us to focus on that.

Mr. Chairman, I, as Senator Cohen, subscribe to the belief that in investment decisions, people should follow what we learned in law school as "caveat emptor"—buyer beware—that people who are purchasing anything have certain responsibilities on their own, that not everything that they do, every business decision they make, the Government will help.

However, after having said that, this hearing raises legitimate questions as to whether some banks are purposely misleading people into placing their savings into more risky investments without properly disclosing these risks. In fact, Mr. Chairman, the Nation's top regulator, the Comptroller of the Currency, has recently criticized a number of banks—and as Senator Cohen said, not all banks, but a number of banks—for not properly telling their customers about the risks the securities that they're selling have.

This problem has grown in recent years as more banks have gone into the securities business. Today's hearing presents an opportunity for some very well-put-together witness panels to sound the alarm, and I personally, Mr. Chairman, plan to alert my constituents in Nevada that seniors should be aware and beware of products being pushed by their friendly local banker.

This is a new problem, because until recent years there was something we called the Glass-Steagall Act that prohibited banks from owning brokerage, prevented the sales of securities by banks, and other such things, and the reason for that was very simple. Was it right to come into a bank and ask for a loan and the bank says, "Yes, we'll be happy to loan you the money, but how would you like to invest in some of our securities?" and there could be an implied threat that if you didn't do it this time, you might not get the loan or might not get the loan next time? That's why we had the Glass-Steagall Act. But these regulations have loosened, and banks have recently been rushing to sell securities.

This hearing is not designed to question this new reality. That's here, and this Committee is not going to change that. Our concern is that deceptive sale practices need to be stopped. The reason this committee is concerned with the particular behavior of banks is that they parade under the banner of "FDIC insured" that hangs on the front door of every bank in America, leading to a false sense of security among customers that every dollar placed there is protected by the Federal Government. In fact, they have the little ones

that you've seen on some desks when you're talking to one of the bank officers that says "FDIC insured," but it just doesn't say what is insured.

I think that I would suggest, Mr. Chairman, that the very least that we could recommend is that banks that sell securities should also have a sign that says words to the effect of "not everything we do is FDIC insured" rather than have a sign that says "FDIC insured" and it's only part of what they do.

When seniors talk with their local banker about investment opportunities, they may not realize that they may be talking to a broker hired by the bank—not working for the bank, but hired by the bank—to steer customers into buying their own line of mutual funds or other securities. We'll hear testimony today about a survey that found many institutions are failing to disclose fees to customers or to tell them that securities, unlike deposits, are not insured by the Federal Government. We'll also hear today that even sophisticated bank customers can be mislead. The bank is seen by many as a protector of money, not a place to invest.

Mr. Chairman, as I was looking through some of your notes here, letters that have been prepared by staff, it reminds me of a time that my wife was in an accident, and for each of the kids who were in the accident with her, we put up a little bit of money that came from the settlement of the lawsuit. Well, I couldn't figure out why they were losing money, and it was because of one of these deals, that it was put in Fannie Mae or something like that because interest rates, they thought, would be higher, but they lost money rather than made money. So relatively sophisticated people can be mislead. Banks should tell every potential investor that the securities are not insured. If necessary, as I indicated, we should change the signage.

Today's hearing is designed to make sure that the caveat emptor principle works in practice—that is, buyers beware, but they can only be aware of what they understand. If customers are properly advised about the risks involved, they're more likely to make proper decisions that will ensure they're security during retirement years.

Thank you, Mr. Chairman.

Senator PRYOR. Thank you, Senator Reid. We appreciate your participation this morning.

I know that there are a lot of committees going on. We're trying to wind down this session of Congress, and people will be coming and going, and we hope that you will accept our apology for sometimes the confusion. I don't think that there are going to be any votes this morning, but there could well be. But if there are, we will leave and go and vote and come back momentarily.

First panel this morning. The first two witnesses will be Leilani DeMint and Mr. Max Wells. They are bank customers who recently purchased uninsured products from their bank. Ms. DeMint is a 53-year-old mother from Florida. We welcome her son, Edward, who is with her today. She works for the State of Florida. Mr. Wells is a 66-year-old retired Federal employee who is also a resident of the State of Florida.

The second two witnesses in our first panel are Catherine Hovis and Laura Park. Ms. Hovis and Ms. Park are brokers who recently

worked in a bank setting. Ms. Park is a resident of Florida. She has worked as a broker in several different banks since 1981, and she is a certified financial planner and a chartered financial analyst. Ms. Hovis is a single mother who resides in Tampa, FL. She spent almost 5 years working for banks and bank brokerages, and she currently works in the securities field in brokerage.

Let me also state this: Because of several lawsuits that are pending or may be pending, and because of several arbitration disputes which are in existence today, we have asked our witnesses to withhold the names of the banks and the financial institutions that are involved. We think that that is just good sense. These individuals have been very courageous to come here this morning. They have been selected out of a large number of people to testify because we think that their stories are in fact representative of other bank customers throughout our country and also brokers that our staff has interviewed over the course of the Committee's investigation.

So without further ado, we will ask our panel to begin. We would encourage our panel to basically limit your comments to 5 to 7 minutes, if possible. Your full statement will be placed in the record. You may read it, or you may summarize your statement, or you may just want to speak at random.

Ms. DeMint, we would ask you to go first. If you would just state your story, please, to the Committee.

STATEMENT OF LEILANI J. DeMINT, INVESTOR, ST. PETERSBURG, FL

Ms. DeMint. Yes, sir. In the spring of 1993, I had a CD come due at a local bank in the amount of $57,000. I had checked other bank rates. The bank that was holding my CD told me that they could offer me Government bonds paying 6 to 7 percent. A male representative called me back, I made an appointment, I went down to the bank itself that I had been dealing with. His office was located in the lobby.

I sat there and talked to him, and he told me that these bonds could fluctuate as far as the interest, that it would range between 6 and 7 percent, but the interest rate would never go below 5 percent. He said it would be comparable to a CD, that I would be locked in for 5 years and it would mature in 5 years, and that if I did withdraw my money, there would be a penalty for early withdrawal.

He represented himself as a bank employee verbally, visually, and he handed me his card with the bank's name on it and his name on it. I gave him—well, the customer service representative that worked for the bank, and I know she did work for the bank, because she dealt with my checking account and different things before—she took care of getting the money, the $57,000. I went ahead and gave him a check for $3,000, because he said it should be in even increments, that I could add to this in $10,000 increments. So I did. I told him that I wanted the bonds, I did not want some computer readout. He said that would be fine, no problem.

I received a receipt from him. It was a piece of paper like you get for a CD, and it had the bank's name on it. I had no idea that I was dealing with anything other than the bank itself. I thought

I was buying some type of bonds, Federal Government bonds, like savings bonds is what I was under the impression I was buying.

A month later I took another $10,000 down there. I did not see the male representative at that time. The female, the young lady that worked for the bank itself, took care of the whole transaction.

It was several months later and I hadn't received my bonds. I was waiting for them. I called, and they said I should be hearing something pretty soon. This was in the fall. And I did. I received a piece of paper from a company. For my $60,000 over to the right, it said the account was $61,000. Over to the left, it was that I had earned over $2,000 interest. So I called this company, thinking it was a mathematical error. Well, there was no mathematical error. The other $10,000 was not even put in with this company. It was put with another company which I knew nothing about. They told me I was lucky I had not lost any of my principal.

I am not going to sit here and tell you how I felt emotionally. This was one old lady that was pulling her hair out and crying big time. It was terrible. The money that we're talking about, sir, is money that my mother left me. My mother was killed by a drunk driver 4 years ago. This was not lawsuit money. This was money that my mother scrimped and saved. My son Edward is autistic, and this money was to be held for his future to provide a little security for him. I know it's not much, but it was all we had.

Anyway, the $70,000—I ended up withdrawing all of the money in 1994, and I put it in a bank in Tampa, in a CD. They signed it in blood, believe me. It's in a real CD.

I don't know what else to tell you at this point. I have been completely, completely, deceived. I really totally believed I was dealing with a bank, the bank was taking care of buying these bonds. And 6 to 7 percent was not something—if they would have offered me 14, 15 percent, I would have been skeptical. I would have said, you know, "This is a large amount of money right now to be paying," but 6 to 7 percent did not seem something that was so out of the question. CD's were paying 4 and 5 percent at the time. So I went ahead and went with it. I was certain I was buying Government bonds. Needless to say, I did not have Government bonds. I had some kind of mutual funds.

[The prepared statement of Ms. DeMint follows:]

TESTIMONY OF LEILANI J. DeMINT

SENATE SPECIAL COMMITTEE ON AGING

"Uninsured Bank Products: Risky Business for Seniors?"

September 29, 1994

I want to thank Senator Pryor and Senator Cohen for inviting me to be here today. I appreciate the interest which the Senate Committee has taken in this problem. I know that this is a matter of great concern to Senator Pryor and to Senator Cohen.

My name is Leilani Jaskinski DeMint and I am a 53 year old, single mother, from St. Petersburg, Florida. I work for the State of Florida in the operation of toll booths in the Tampa area. I live in St. Petersburg with my 28 year old autistic son, Edward Ringwald, of whom I am very proud. We are not rich by anyone's standards, but we make enough to get by. The money we have managed to accumulate is extremely important to me and to my son's future security. My major concern is that there will be enough money to take care of my son when I am no longer able to do so.

My son and I moved in with my mother in 1973 and we lived with her until she was killed by a drunk driver in 1990. During these years, my mother and I were able to scrimp and save with the thought that we were sacrificing so that my son would have some money for his future needs. We had always kept our money in the bank and I had never used a brokerage for any purpose. Frankly, I do not understand what goes on at a brokerage and I do not understand the kinds of things they sell. I have never been willing to take a risk with what little money I had and that's why I always put it in the bank. When my mother died in 1990, we had accumulated what was, for us, a lot of money. I placed this money in Certificates of Deposit in several different banks and credit union in an attempt to get good interest rates. I chose to put my money in Certificates of Deposit because I wanted my money to be safe and in the bank. I did not want to take any chances with this money.

In the Spring of 1993, one of my CDs matured at the Bank. I called all the different banks in the area to find the best rates of interest on Certificates of Deposit. When I contacted the Bank which currently held my CD, they informed me that they would have a better deal for me and would be back in touch. A man called me from the Bank and told me that he could get a higher interest rate then I had been quoted by other banks and, after he called me several more times, I agreed to come to the Bank and talk to him.

I went down to the Bank and I met with the Customer Service Representative to discuss my CD. She then introduced me to the man I had spoken with on the phone and he gave me a card with the Bank's name on it. We talked for a short period of time, and he told me that they could get me a higher rate of interest by having the Bank purchase government bonds for me. He said that the interest I would receive might fluctuate but that my principal would not be in danger. I told him that, if my money was safe, I would buy the government bonds.

I trusted the Bank and I signed the papers he asked me to sign. The CD that came due was for $57,000.00 and I wrote a check for $3,000.00 to the Bank to make it an even $60,000.00. He gave me a receipt with the Bank's name on it and that was all. Again, I was not suspicious because I trusted the Bank and I was in the Bank.

At this time, I was also told that I was welcome to invest additional money in this account. In fact, approximately one month later, I withdrew another $10,000.00 from a credit union. I figured that I was better off with the higher rate of interest the Bank had promised. I took this additional $10,000.00 into the Bank and gave it to the Customer Service Representative. She took my check and gave me a receipt.

I did not receive anything else for several months, but I was not worried because I trusted the Bank. When I had deposited my original $57,000.00 in a CD with the Bank, the only paperwork I received was a receipt. I didn't have any idea that anything was wrong. Finally, in the Fall of 1993, I called the Bank because I hadn't heard anything and had not received anything else. I told the Bank that I wanted to receive the actual bonds that were purchased so that I could put them in my safe deposit box. I thought I bought savings bonds. Again, I was assured that everything was all right.

Well, to make a long story short, everything was not all right. After my call to the Bank in the Fall of 1993, I received a statement from a company I had never head of. I did not recognize the name. They said that they had my money. Since the Spring, I had earned about $2,000.00 of interest, they said. But, the statement said that the value of my account was around $61,000.00. I did not understand how I could have earned about $2,000.00 in interest on $60,000.00 and have an account balance of $61,000.00. I called this company and they explained to me that I was lucky I had not lost more of my principal. At that time, I became extremely upset and concerned.

The people at this company did their best to explain to me what I had purchased but, to this day, I still do not understand it. They told me that my money had been placed into a mutual fund and I told them that this was not what I had wanted or had asked for. I was extremely frightened by their comment that I could have lost my money and I then contacted the Bank in an attempt to get this mess straightened out.

I did not receive a favorable response from the Bank. They were not concerned about my complaints and told me that if I wanted to get out of this mutual fund, I would have to pay a penalty. When I had agreed to give my $60,000.00 to the Bank, I was told that there was a "penalty for early withdrawal" (like a CD). I was told that I would have to leave the money in the account for at least five years. My CD had a penalty for taking out the money early so this did not concern me. At any rate, I asked the Bank to give me back my money so that I could put it into CDs where my principal would not be at risk. The Bank refused and told me that if I wanted to sell the mutual fund, I would have to pay the penalty and then I could do whatever I wanted with the money. The Bank told me it was my problem, not theirs.

Around this time, I had also found out that the additional $10,000.00 I had given the Bank had been invested in another mutual fund which I also had to pay a penalty to get out of. This was never discussed with me and I was very angry about this as well.

Again, I went to the Bank and pleaded with them to fix this mess. I could not believe that the Bank would not help me with this as I trusted them due to our long relationship. I had been to the Bank numerous times and I had a checking account, a savings account and even a VISA card with the Bank. I trusted them but they deceived me.

When the Bank refused to give me back my money, I wrote to the President of the Bank and to the Office of the Comptroller of the Currency. I was told that the Comptroller would "look into it" but nothing was ever done. The President of the Bank did not even have the courtesy to respond to my letter. I did not understand what was going on and I could not get anyone, including the Bank, to help me. All I could see was that the value of my account was continuing to go down each month that I received a statement. Finally, when I could not get any help from anybody and realized that I was going to continue to lose the money my mother and I worked so hard to save, I sold the mutual funds and paid the penalties to get out. I immediately took the money to another

bank, and after confirming that they had no dealings with the Bank I had just left, I deposited the money into a Certificate of Deposit. That's where my money is today.

Unfortunately, there is a lot less money than there used to be. During this time, I lost 10% of the money we had worked and sacrificed to save and I had to pay taxes on the money they claim that I made in interest during this time. I couldn't understand why I had to pay taxes on money I had lost. Again, I still do not understand what has happened to me and I remain extremely wary of brokerages and places like that. And now, places like that include the Bank. I would never have guessed that they would treat me this way. I knew them and trusted them and they knew me. I told them about my son and his special needs and they knew that I could not, and did not want to, risk losing any of this money. I told them over and over that I did not want any risk. They simply didn't listen to me and they didn't care about me. The man who called from the Bank never told me he was a broker. If he had, I would not have talked to him any further. I thought I was dealing with the Bank and that's what they wanted me to think.

The Bank should not be allowed to do this. People like me with special circumstances and people in their retirement years do not want, and cannot afford to, take chances with their money. Its all we have.

Senator PRYOR. We're going to have some questions momentarily, Ms. DeMint, to ask you about this, and we will let you expand on your statement momentarily. A very good statement, and we thank you.

Now we're going to call on Mr. Max Wells, also another investor.

STATEMENT OF MAX L. WELLS, INVESTOR, ST. PETERSBURG, FLORIDA

Mr. WELLS. Yes, sir. I had a thrift savings that generated from when I was working as a policeman at the VA in Bay Pines, FL, and this money was accumulated by taking so much away from your earnings each payday. Mine got to be $5,400 approximately, not a lot of money.

But, anyway, I was at this bank talking to a bank teller who is a friend enough that we were on a first-name basis, and I was telling her—I was checking on a CD that was going to mature, but in the course of the conversation, I was telling her I'm turning 65, I have $5,000 I have to take out of a thrift savings, and I wanted to get a CD, and she said, "Well, the bank has an account that pays you 5 percent guaranteed if you put your money in for 5 years. The only penalty would be if you withdrew your money, then you would be penalized 5 percent." So I told her, "Great! Five percent for 5 years, no problem."

I couldn't get the money out myself, personally. I had to sign a statement or something for the bank to get the money. She told me to talk to a gentleman that was sitting at a desk that I had conducted bank business with before, so I felt no problem with it. I went over and told the gentleman the same story I told her, and he got out a form, which I signed, and I left the bank with just a receipt of this form that I signed. The form was just to get the money out of the fund into the bank. I never saw the money myself.

So after the money was released, I got a statement from the thrift savings sending me a copy of the check, and the check was made out to the clerk that I had talked to. Then, a couple of months later, I got a prospectus telling me that I was into Government securities. So I merely went down to the bank and asked about this, but the gentleman that I dealt with wasn't there, and the lady was on maternity leave, so I couldn't see anyone that I had dealt with. The clerks I talked with told me, "There's nothing we can do for you. You have to talk to the gentleman." So I left, and probably about a month later I went back. Same thing again.

Finally, the lady came back, and I saw her, and I talked with her. She told me I would have to talk to another gentleman, because the gentleman that I had dealt with was no longer with the bank. This gentleman told me, "Well, yes, your money has been put in an account that if you withdraw this money now, it's going to cost you 5 percent," but he couldn't explain to me why I was losing money. I think my money had gone down approximately $500 or something, and I'm just happy really because it wasn't a lot of money. It wasn't all the money I had.

So, anyway, I said, OK, I would just take the loss. Now, I was willing to accept this loss because I was too small to fight the big bank. Fortunately for me, I was reading the paper, and I read the

story about Ms. DeMint. So the only thing I could do was say maybe I could be of service to her, so I called and agreed to be a witness for her because of the same thing that happened to me. I explained my story, the same identical thing that happened to me by the same bank, by the same gentleman that took my money.

So basically that is the reason why I am here and got involved with this thing, because I just felt I had lost my money, just being small.

[The prepared statement of Mr. Wells follows:]

TESTIMONY OF MAX L. WELLS

SENATE SPECIAL COMMITTEE ON AGING

"Uninsured Bank Products: Risky Business for Seniors?"

September 29, 1994

Before beginning my testimony, I want to thank Senator Pryor, the Chairman of the Committee. I understand that Senator Pryor has taken a lead in protecting the rights of the elderly, the retired, and the consumers. I also understand Senator Cohen and his staff have been very concerned about the problem with bank securities. I appreciate the fine work of both Senator Pryor and Senator Cohen in bringing this issue to the public's attention.

My name is Max L. Wells and I am a 66 year old retired Federal employee. I am a native of Florida and, after serving in the military, I served as a police officer at a Veterans facility in Bay Pines, Florida, until my retirement. My wife and I currently reside in St. Petersburg, Florida.

I had a good relationship with the Bank until I began looking for a place to invest my thrift savings account. While I was a Federal employee, I was allowed to put in a small percentage of my earnings and the government paid interest on that. I was able to accumulate around $5,400.00 in this thrift savings account. That was only part of my savings, but I could not afford to lose any money at my age.

I went into the Bank to talk with them about bringing my thrift savings plan into the Bank. I had other accounts with the Bank. I had a good relationship with the people there. When I entered the Bank lobby, I was met by the Customer Service Representative I had dealt with many times before. In fact, I considered her to be more than just a Bank employee; I considered her to be a friend. When I told her about this money, she told me that the Bank had a better deal and that they could get me 5% interest as long as I kept the money in the account for five years. They told me that if I took my money out early, there would be a "penalty". I had bought Certificates of Deposit before, so this did not alarm me. My only desire was that my money be safe and that I earned the best interest I could.

The Bank's Customer Service Representative introduced me to a man in the Bank lobby; he was at his desk also in the lobby. I spoke with him and signed the papers he asked. The Bank then began the process of transferring my thrift savings plan from the government where it was held. This transaction took place at a desk where I had previously done business with the Bank and I had dealt with other clerks sitting at the same desk. Therefore, I believed him to be a Bank employee. He never told me any different. If he had told me that he was a broker, I would not have dealt with him at all. I know what a broker is. I had lost money with brokerages in the past. I did not want a broker or brokerage. I was not interested in risking my money. I told both of the Bank people that I wanted to make sure that my money was safe. At this time in my life, I was not interested in any risk.

I left the Bank on that day believing that I had placed my money in the Bank and that I would earn a steady rate of interest until the five years was up. No one ever told me that they were purchasing a mutual fund for me. I know what mutual funds are. If anyone had said the words "mutual fund", I would not have signed the papers or bought anything. When I received notification several months later that I had purchased a mutual fund, I immediately contacted the Bank and went down to talk about it.

I had heard of the name of this mutual fund company but I had never seen any information on this fund until I received it in the mail after the Bank took my money. I did my best to read and understand the materials which came to my home and I wanted to discuss with the Bank the fact that it seemed that I had a chance of losing my money. I told them that this was not what I had wanted and not what I had asked for and I asked to see the man who sold me this. The people at the Bank told me that there was nothing the Bank could do. But I never again saw the man who sold me this in the Bank lobby. When I went back another time to look for him, he was gone. I was told that he had left the Bank. I met with the Customer Service Representative again and she met with me along with another gentleman which, to my understanding, had taken the place of the first one. I now know that these men were stockbrokers although this was never disclosed to me at the time of my investment or during my complaints.

I again told the Bank that I was not interested in a mutual fund and I wanted my money back. I told them that I could not afford to risk my principal and that I needed my money in a safe place. The clerk at the Bank told me there was nothing I could do and that if I wanted to get out of the mutual fund, I would have to

pay the penalty. I tried and tried to reason with the Bank; they simply did not care about me. I was too small to fight with them and knew that it would cost me a lot of time and money to try to do anything. Its like when the bully takes your quarter; you have to decide whether you can get your quarter back and, even if you do, if it will be worth the beating you have to take.

Because I could not get anywhere with the Bank, I kept the mutual fund for awhile. I hoped that it would begin going up in value so that I might not lose so much of my money. Unfortunately, the exact opposite happened. Each month when I got a statement, I saw that the mutual fund was going down. I did not want to gamble with this money but, now that the Bank had put me in this position, I figured that I had to make the best of it. I did some research and decided to move my money into another fund which was a little riskier but had a better potential to get back the money I had lost. I am stuck with this fund, hoping I will get back some of my money, but it may not happen. I just wanted to put my money in the Bank and not have to worry about these things. Even if I had only earned 3 or 4% interest on a Certificate of Deposit, at least my principal would have been safe and I would have made some money. Now, I don't even know if I can make enough money to make up the money I lost.

While this is not all the money I have, it could have been. This is what concerns me most about what the Bank is doing. People of my age need their money and they do not want to take a chance on losing it. Had I invested all of my money in this account, which could have easily happened, I don't know where I would be. And, obviously, the Bank didn't care. Before this, I considered myself to be pretty knowledgeable regarding investments. If they can trick me, I am concerned for all people out there who don't know anything about the investments the Bank is selling. If the Bank had just been honest with me, I would not have purchased the mutual fund but I would have put my money in the Bank. I don't know why that is not good enough for them. Since I am their customer, I would think that what I want should be the most important thing.

I think this situation creates a special problem for people like me with IRA money. It is my understanding that you have to mandatorily withdraw your money at age 70. If I were put into that type of an investment with my IRA, I would be forced to take the money out regardless of how much had been lost. Elderly people with retirement accounts could never recover their losses and would end up with a lot less money than if they had just left it in CDs.

I consider myself lucky because the Bank only took a portion of what I had. I believe that the Bank is deliberately abusing its position and taking advantage of its clients. That's why I wrote to my representative; I believe that something has to be done. When I went to the Bank to discuss what had happened to me, I didn't get any type of consideration. I was told more or less that you are in it now and the only way you can get out of it is to sell it and lose 5% and that's that. The Bank did not care about what I wanted or what happened to me.

It is also scary because it almost happened to me again. Earlier this year, when I went into another bank to talk about my CD which was maturing, one of the bank clerks immediately wanted to refer me to another man in the bank. I told her that I had heard this story before and that I wanted a Certificate of Deposit. I told them that I did not want any part of a broker.

This experience convinced me that this is not an isolated incident but it is the way that the banks are trying to do business. It used to be that when you wanted to put your money in the bank you could and now, even when you think you're putting your money in the bank, you can't be sure. The sole reason that I went to the Bank was for safety and security. I trusted the Bank and they took advantage of that trust. And what hurt me was that the next bank I went to tried to do the same thing. I believe that banks should focus on what the customer needs and, especially in our retirement years, what we need is security; and the banks are simply not giving us that.

Finally, some of the people in the Bank do care. When the Customer Service Representative found out I had lost money, she was extremely upset. I don't think they understand what the Bank is doing.

Senator PRYOR. We certainly appreciate you coming also this morning Mr. Wells. In a moment we're going to allow our committee members to ask you a few questions, if that's possible, about some of the details of your transactions. We're going to let you expand and illuminate on those details.

Mr. WELLS. May I add just one thing, sir?

Senator PRYOR. Certainly, Mr. Wells.

Mr. WELLS. One thing is that I do have a little knowledge about investments. I have bought a lot of mutual funds. So when people took me on this deal, it wasn't because I was ignorant as to what they were doing. They told me the bank had an account, and that was the magic words: "the bank had an account."

Senator PRYOR. Let me ask one question now. We're not getting into questions yet, but the person you dealt with in the bank, was he a bank employee or not?

Mr. WELLS. I thought he was. It was not until I received the prospectus and went back to talk to him that they told me he was not a bank employee.

Senator PRYOR. He was not an employee of the bank?

Mr. WELLS. Right.

Senator PRYOR. I see. He was an employee of this fund or someone else's employee.

Mr. WELLS. At that time, nothing was said about a fund, sir. I had no idea there was a fund or anything.

Senator PRYOR. OK. Well, two of our witnesses now have given their testimony, and by the way, if you have any written testimony, it will be placed in the record. I have read the written testimony of each of our participants this morning. I find it very, very instructive.

Let me next introduce Senator Riegle. Senator Riegle from Michigan is one of the newer members of this Committee, and we are very proud that he is the Chairman of the Senate Banking Committee, and he has jurisdiction over all the banks, so we might, before we go to our next two witnesses, hear from Senator Riegle and then from our friend from Montana, Senator Burns.

Senator Riegle, we welcome you this morning.

STATEMENT OF SENATOR DONALD W. RIEGLE, JR.

Senator RIEGLE. Thank you very much, Chairman Pryor. Let me congratulate you and commend you for having these hearings, and I want to thank the witnesses for coming. I'm very interested in Mr. Wells' story, which I've just listened to.

One of the things that I want to pledge to you, Mr. Chairman, and to the witnesses is, based on your hearing record and your findings and observations, I would like you to convey that to us in the Banking Committee so that we could look at it to see what steps we might consider taking.

Just this past week, President Clinton signed into law a bill on banking. It puts a stop to a practice that has been done by some financial institutions of going out and offering very high interest rates to people who need home equity loans. The rate of interest is so high that it, in effect, steals the person's home because they can't make the payments. The finance companies doing this know that they're putting, in many cases, a senior citizen in an impos-

sible situation to pay this back and will end up getting the house as a result of it. So that's one practice that we've identified and just put a stop to.

In terms of either misinformation or disinformation or a lack of proper notice as to what is being offered as a financial product in a bank that has Federal deposit insurance, we have got to solve that problem. We can't have a situation where, either accidentally or deliberately, you have got people being misled in terms of moving their savings from one kind of a savings instrument to another.

I'm struck by the fact that, as you say, you have experience in this area. You've bought mutual funds, so you were not a novice. But nevertheless it was portrayed to you in such a way that you were led to think that this was a bank product and, therefore, under the umbrella presumably of deposit insurance. You were led to believe that you wouldn't see an erosion of your principal—in other words, whatever you put in, you would in the end get that back, plus whatever the rate of interest that they were promising you. When you went back part of your principal had in fact disappeared. Five hundred dollars, you say.

Mr. WELLS. Approximately, yes, sir.

Senator RIEGLE. Approximately. So you not only were misled, but you took an economic loss as a result of this. I take it that this fellow who sold this product was sitting there as if he were a bank employee? Does the bank say he was or wasn't part of their operation? Was he an independent operator sitting in there with their approval, or was he actually part of the bank structure, or do you know as you sit here now?

Mr. WELLS. Let's put it this way, sir. If you told me to speak to this gentleman, I would assume that this gentleman was working with you.

Senator RIEGLE. The Committee, sure.

Mr. WELLS. So when the lady told me to go speak to this man, I assumed he was a bank employee. But the thing, as I said before, that really convinced me I was dealing with the bank was when she said the bank has an account. She didn't say that the broker—the word "broker" was never mentioned.

Senator RIEGLE. Well, the Federal deposit insurance that we have in place is there for a reason, and oftentimes people will go to a federally insured institution and they'll get a lower rate of return on their savings, but in return they get the protection knowing that the money is absolutely protected, at least up to $100,000, and then when you go back to get the money, the money's going to be there, and that was the presumption that you were operating under.

Senator REID. Senator Riegle, would you yield?

Senator RIEGLE. Yes, of course.

Senator REID. Prior to your getting here, I asked a question. When you walk into a bank, it says "FDIC insured," but, of course, the other operations they have do not have that little tag that applies to them. What would it take to have in these banks that do things other than taking your money and putting it in a savings account or checking account—what would it take to have a sign that said "Everything here is not FDIC insured" or words to that effect?

Senator RIEGLE. Well, that would be one approach. Another approach would be to say that any product that they're offering—it could vary from State to State and that gets to be one of the wrinkles here—would have to have on it in bold-face print right up front, "This is not federally insured." In other words, there's a formal disclosure, and not just in writing, because sometimes fine print can be made so fine that you can have perfect eyesight and not see it.

Senator REID. Could that be done by regulation?

Senator RIEGLE. I'd have to check that. It would depend on product type and the State that was involved. In addition to a notice that makes that clear I think there's an additional obligation. I think there should be an oral statement to that effect. In other words, I think every employee that's handling these kinds of decisions with savers and individuals should have an affirmative obligation. If it's not federally insured, say so, so you hear it in your ears as well as get it on some kind of a disclosure document so you know exactly what you're doing. You want that product, that's one thing, but you shouldn't be misled, you shouldn't be steered into a product that is not what you want and in fact puts you at risk. So we'll work with you to try to find an answer to this problem.

Senator PRYOR. We want to thank you, Mr. Chairman.

Senator RIEGLE. And if I can say one other thing, Mr. Chairman, because this may be my last opportunity to appear on this Committee, I want to thank you for your leadership on these issues now for nearly 30 years.

Senator Pryor started out on the issues of senior citizens on all matters of problems and issues—Social Security, fraud activities, lack of assistance in key areas, and so forth. Over in the House of Representatives years ago when we had no Aging Committee, he set up a trailer out on the lawn over the objection of the leaders of the House in order to get a focus on the problems facing senior citizens. That was 30 years ago, and he's here today doing the exact same thing, and to my mind that's one of the great acts of leadership that I've seen here in Washington in my time here. So I congratulate the Chairman.

Senator PRYOR. Thank you, Don Riegle, for that, and I appreciate that.

We're going to allow Senator Burns now to make a statement, and then we're going to our next two witnesses.

Senator Burns.

STATEMENT OF SENATOR CONRAD BURNS

Senator BURNS. Well, thank you, Mr. Chairman, and thank you for holding this hearing. I would just submit my statement for the record, with just a short statement. And thank you for having this hearing. Both you and the ranking member, my friend from Maine, have done so much as far as fraud in the Medicare system and these things that can beset our older Americans.

We were pretty surprised in this coming up, so we contacted our banks in Montana, and they were just as surprised as we were. They having no complaints with regard to this. Now, I can see where it could be a problem, and I don't want to throw any cold water here on this thing, but then we contacted our commissioner

that is in charge of the banking institutions in Montana, and he was just as surprised. No complaints have been filed in the State of Montana with regard to this subject.

So I'm very interested in hearing the testimony today. Maybe we could avoid some things in my State that have beset you. I'm thinking probably it's more of an education process than regulation process. I don't know what regulations we could pass that could help in this regard, other than—you know, it's okay to pursue the thing, and it's okay to put a guy in jail, but your money's still gone. So I think how we attack this is going to have a lot to do with it.

I appreciate the hearings on this, though, because what we're hearing in the country—my mother's 85 in Missouri, and she gets telephone calls every night about scams, and I told her about this hearing when I was talking to her last night, and she said she had never heard of this before, and I said, "Well, you might be aware of it," and I think some of us have an obligation to our elderly folks to make sure of that.

So, Mr. Chairman, thank you for this hearing. I think it's worthwhile, and I look forward to hearing the testimony.

[The prepared statement of Senator Burns follows:]

PREPARED STATEMENT OF SENATOR CONRAD BURNS

Good morning, Mr. Chairman, and thank you for holding this hearing today. You know, when I heard what the topic of today's hearing would be, I was intrigued. I know, from past hearings we've held, how vulnerable our senior population is. They tend to be targeted for all sorts of schemes. And with their income often being fixed, they don't have far to fall.

But I didn't imagine that our banks, whether local or national, would be party to this. I did call my state offices to see if we'd heard from any seniors on this subject, and my staff reacted the same way I did. Fascinated, but no, no seniors had contacted us about deceptive practices by banks. It could well be that Montana's banks, because my state is so community-related, operates on a much more basic level. It could be the seniors are unaware of their products being uninsured or perhaps Montana's seniors ask all the right questions before investing. I truly don't know. Or perhaps, as my colleagues have implied here, maybe this is an under-reported problem.

So I called our Banking commissioner to see if perhaps Montana's banking industry is doing something to prevent this from happening. Again, the same reaction. He knows that it is getting a lot of attention, and it does concern them, but to date there have been no complaints. However he did relay to me a story about a woman he knew, in her golden years who had done exactly what we're talking about here. She had gone into her bank, the banker suggested she might be able to get more for her money investing another way, and she transferred her money to a CD account in a Boston-based bank. Imagine her surprise when the bank went bankrupt and her money was gone. She was luckier than most though, in that the FDIC picked up the pieces and she did get some money back.

I think the problem may be one of education, not necessarily more regulation. The banks in Montana now must follow rules regarding disclosure. They must tell the customer that certain products are not insured. And yet, the customer still puts all their faith and trust in the service they got from that bank, even though they've been told there are no guarantees. I honestly don't know how we can get the message through to the seniors who are investing.

So, I am most interested to see what this hearing uncovers. If it is indeed a problem, as I'm sure our first panel will show us, then I will look forward to hearing their suggestions as to how we can solve it. It is tough enough to earn a living these days, we certainly don't need to make it easy to lose your savings.

Mr. Chairman, I thank you again.

Senator PRYOR. Senator Burns, thank you very, very much.

Now we'll go to our third witness, Laura Park.

STATEMENT OF LAURA A. PARK, BROKER, CERTIFIED FINANCIAL PLANNER AND CHARTERED FINANCIAL ANALYST, PALM HARBOR, FL

Ms. PARK. My most recent position was as a regional sales trainer for a bank. My job was to train bankers to sell bank mutual funds. I'd also like to say that I'm in favor of banks being in the brokerage business, and that I think that mutual funds can be excellent investments even for seniors, and that they play an important part in a well-diversified investment portfolio.

I think the problem is that the banks are abusing the trust of their customers and they are not providing the services that are being advertised. Many bankers and brokers who are selling mutual funds are calling themselves all sorts of grand titles—investment counselors, investment advisors—and it's no wonder that customers are confused. The bankers are confused about what they're selling.

What I have brought with me today are a number of materials, some of them from the course that I taught, and what I'd like to do is make some points, about abuses which I would characterize as subtle and insidious. Many of the regulations that are in place now would be sufficient if they were enforced and followed by the banks both in the spirit and the letter of the law.

One example that comes to mind is the fact that a banker will tell a customer that what they're investing in has a fluctuating net asset value. That, on the face of it, is full disclosure, but I will submit to you that most customers, particularly older customers, do not understand that that means, "Mr. Customer, you could lose your money."

Senator PRYOR. What is the terminology you mentioned?

Ms. PARK. The investment has a fluctuating net asset value.

Senator PRYOR. This senior investor would not know about that, I can promise you that. Thank you.

Senator BURNS. Maybe these folks ought to go in the auction business. They use all kinds of words like that.

[Laughter.]

Senator PRYOR. That's right.

Proceed, please, Ms. Park.

Ms. PARK. The first exhibit I'd like to draw your attention to is a selection of questions from an investor profile that my bankers were trained to use. On this particular exhibit and the one that follows it, there are 10 questions. These were pulled out from a profile form the bankers were instructed to use. The bankers entered the answers to these questions into a computer, and the computer program would then give them one of four models, which were called asset allocation models. We're looking at the asset allocation models at the current time, and the bankers would then make their recommendations to the customer based on which model they felt the customer fell into.

Now, once the bankers did this a few times, they were able, if they wanted to influence the customer to buy a particular product, to influence their answers to the questions to come up with a model that suited their own purposes. This wasn't always the case, but I know in fact that it happened more times than I would like to have seen. If, for example, they say a customer falls into the

growth and income category, they might want to either recommend fixed income investments to the customer or equity investments. They were instructed to analyze the customer's existing investments so that what they recommended was compatible with the customer's current holdings.

Most of the bankers that I trained were not able to do this. They did not have sufficient training. To make it easy for the bankers to recommend a fund, the mutual fund prospectuses were color-coded, so it was as simple as, if the investment was fixed income, that was a red fund, so that the correct investment might be one of the red funds. And yet we are telling our customers that these people are fully trained and licensed to advise them on their investments.

I've also brought excerpts from interviews with successful brokers at the last bank that I worked with, and there are a couple of things I'd like to bring your attention from these interviews. The first one is where Michelle is talking about the fact that she wanted to make it fun for her bankers to make referrals to her, so she had contests where she'd provide, out of her own pocket, prizes and gift certificates of $100. She also was very active in cross-selling—cross-selling bank products so that bankers would cross-sell her products.

Senator PRYOR. Just a minute. She was making money from each sale, right?

Ms. PARK. Yes, that's correct.

Senator PRYOR. Okay. Excuse me.

Ms. PARK. And Joe also is cross-selling products.

I was terminated from my position for making cash payments to bankers who made referrals to me and also for a system of cross-selling. I was terminated in June 1994. This is information that was circulated throughout the bank in July 1994, endorsing, supporting, and promoting these practices. The only conclusion that I can draw from this, is that the real reason I was terminated was because I criticized the inadequacy of the training program that I was forced to deliver to bankers selling investments to senior citizens in Florida.

Senator REID. What is your background and training?

Ms. PARK. I graduated from Smith College and Duke University. I'm a chartered financial analyst and a certified financial planner, and I've been a broker for 14 years.

Senator PRYOR. Well qualified.

Ms. PARK. The last exhibit I have is a flyer from a Call Night, where bankers and brokers might be calling the list of maturing CDs. I'll bring your attention to Blitz Night—"unimaginable wealth and fabulous prizes." Those are for the bankers, not the customers. So there was enormous pressure to sell proprietary funds.

The bankers that I trained, while they were licensed to sell any number of 5,300 mutual funds available, by bank policy were only permitted to sell the bank's funds. If they referred the customer to a broker with a broader license who could make a full range of products available, they received no sales credit and they received no commission income. There was tremendous incentive and pressure to sell the bank's funds, and yet in the bank that I was with last, the customer's first contact was with the banker, who was just

selling a limited product base and who had extremely limited training.

[The prepared statement of Ms. Park follows:]

TESTIMONY OF LAURA ANDERSON PARK

SENATE SPECIAL COMMITTEE ON AGING

"Uninsured Bank Products: Risky Business for Seniors?"

September 29, 1994

It is important to acknowledge that Senator Pryor and Senator Cohen have invited me to appear today. It is also important to acknowledge that I appreciate the work of Senator Pryor and it is very important work. I want to thank the Senator for his interest. I hope that my testimony will be helpful in solving what I think to be a major problem in the banking industry.

My name is Laura Anderson Park and I am a resident of Palm Harbor, Florida. I have worked as a broker within several different banks since receiving my original license in 1981. I currently hold a Series 7, a Series 63 and a Series 24 license. I am a certified financial planner and I am a chartered financial analyst. The only investments I cannot sell are commodities and insurance products.

I relocated to Florida in 1988 and later began working with the Bank. At that time, I was in a retail center in a free-standing brokerage office. I received some Bank referrals but my business primarily came from walk-ups. The Bank had introduced proprietary funds which had a name completely dissimilar to that of the Bank. These were funds with no load and, while the brokers were encouraged to sell them, there was not a lot of activity in these funds because no one made a lot of money on them. However, the referrals and activity with respect to proprietary Bank products began to escalate in 1992 and early 1993.

Sometime in 1992, a sales charge was added to these proprietary mutual funds. In January of 1993, the name of the funds was changed to mirror the name of the Bank and a contingent deferred sales charge, or CDSC, was added to the funds at that time as well. The Bank made a big commitment for mutual funds to be a major product line within the Bank. This resulted in an incredible amount of pressure to sell the proprietary mutual funds. Not only were brokers provided with "sales quota goals" that they must meet, sales lists were made public throughout the Bank so that everyone knew whether you were selling proprietary funds and how much money you were generating. This list was very important among the people in the Bank. A number of contests with prizes, cash awards, extra

incentive payments, trips and the like were undertaken to encourage referral of Bank customers to the brokerage by Bank personnel and the sale of proprietary funds by the brokers once the referrals were made. There were signs and banners throughout the Bank, even in the areas where money was accepted and FDIC insured transactions took place. The Bank representatives and personnel were placed in T-shirts which said "`PROPRIETARY BANK' FUND - ASK ME FOR A PROSPECTUS". There were cash payments to the Bank employees for referrals to brokers that resulted in sales of a certain dollar amount and the Bankers got points and bonuses for such sales as well. Prospectuses from the proprietary mutual funds were drop-shipped to the Bank branches so that the Bank's employees had them. Basically, the Bank employees and tellers were given the responsibilities and orders to make sure that Bank customers were told about proprietary mutual funds and the employees were rewarded for doing so. The Bank put these people in T-shirts, put signs up all over the branch and paid them an incentive if a sale was made. The Bank did not provide them with any training as to what could and could not be discussed with the customers. Many bank employees were not licensed to sell securities at this point and most simply did not know what they could and could not say to a customer. It is completely unreasonable to believe that the Bank teller will hand a prospectus to a customer and point them to the brokerage without saying anything else. Indeed, there is no way that a customer would proceed to the brokerage unless the Bank employee made some representations about what the Bank was trying to sell the customer.

Instead of realizing this problem and taking steps to eliminate confusion between the Bank and these uninsured, non-depository investments, the Bank made the decision to exploit it even further. The Bank has now undertaken a mass effort to obtain Series 6 licenses for its Customer Service Representatives throughout Florida. This allows Customer Service Representatives who open checking accounts and sell Certificates of Deposit to also sell proprietary mutual funds.

During my tenure with the Bank, one of my duties was to train Bank personnel. In the short time that I was given to meet with these people, I was instructed to concentrate on how to close the sale of the proprietary mutual fund rather than how to give competent investment advice. Most of the Customer Service

Representatives are not qualified to give investment advice and, as a result, the recommendations made to Bank customers that they should purchase proprietary mutual funds could be based only upon sales quotas and financial incentives. I think, especially for the elderly people who trust their bankers, the dual role of selling both uninsured and insured products is extremely dangerous. A customer who has a relationship with the Bank, one of trust, and who has always trusted the Bank for advice, is now being put into an investment with a fluctuating value, and which may or may not be suitable. Elderly and other customers have always dealt with their banker in opening CDs and checking accounts and now the same person is selling them an uninsured, potentially risky investment product. Frankly, the confusion created by this is overwhelming. Still, the Bank employees' mandate was to sell only proprietary mutual funds and that was the only way that employees could get any financial reward and avoid reprimand or even termination.

Sadly, the same was true of the brokers employed by the Bank. While the brokers did have the ability to sell other funds, the payout was skewed significantly toward selling the proprietary funds. In order to make a living, a broker would be forced to sell the proprietary mutual funds of the Bank. At certain times, there were various "goals" that I had to reach in order to keep my position and there were always various sales contests in which brokers received extra payouts for selling proprietary funds. The clear message of the Bank was that if you wished to advance within the organization, you played the company game. You sell the Bank proprietary mutual funds.

What is so egregious here is that the Bank employees have a double disincentive against selling anything else but the proprietary fund. The Bank employees have sales goals based solely upon the sale of proprietary mutual funds and they do not make any money if they turn that customer over to someone else. The Series 7 brokers are effectively turned into quasi-sales managers although without the authority (or training) to supervise the Bank employees. Regardless, the Series 7 broker did not and could not supervise the Bank employees' activities and did not monitor what was said to customers. And, even if the customer managed to be referred to a Series 7 broker, that broker also had tremendous financial incentives to sell only proprietary funds to that customer. The financial and career advancement penalties were just too great for any Bank employee or broker to sell a non-proprietary investment product to a Bank customer.

After the Bank employees received a Series 6 license, the Bank created a five day, forty hour class to help provide those Bank employees with some training. I was promoted out of direct sales into a training advisory position although I still had the ability to make sales. One of the things I objected to when I first looked at the training materials was that it was a sales and operations course and that virtually no time in the five day class was devoted to any investment theory. The only thing these people were taught was to sell the proprietary funds and I felt that these Bank employees who were not licensed brokers should not be providing investment advice without some basis for doing so. The Bank had various funds which were color-coded to match general categories such as growtn and income. There was a computer program developed at some point which asked ten questions and, based upon those answers, would recommend an asset allocation model which was color-coded. The Bank employee would then pick whatever proprietary mutual fund was within that color-code, usually the fund which was being pushed or which was the subject of a contest or extra payout, and sell it to the customer. The problem is that this Bank employee had no knowledge about the type of fund he or she was selling nor whether it was the best investment for the customer based upon other economic factors. Bank employees also did not have any way to compare the proprietary mutual funds with other investment products or even other mutual funds. They simply did not understand what they were selling. This, coupled with the fact that Bank customers cannot distinguish this investment from any other investment sold by the Bank, makes the Bank's practices confusing and dangerous, especially to elderly customers who trust the Bank.

Ironically, I was fired from the Bank subsequent to my complaints about the system and the reason given for my termination was that I utilized unlicensed Bank personnel to sell an uninsured investment product. The customer who purchased the fund became unhappy with its performance and came back into the Bank and complained because the Bank employee was not licensed to sell securities. This was another incident of Bank employees not knowing how far they could go with "pre-selling" the funds before referring them to the broker. The Bank employee was acting under the orders of the Bank and receiving financial remuneration from the deal; however, when the customer complained, the Bank blamed me. The Bank employee in question is still with the Bank and, in fact, is a valued employee. This was the first complaint I had

ever had from any customer dating back to 1981 when I was first licensed. I believe that this complaint was the result of the system set up by the Bank and I do not believe that individuals who participate in this system in order to survive should be singled out as being responsible. However, I accept full responsibility for my role in this: in going along with what the Bank wanted, I was wrong.

I think the solutions to this problem are to have greater separation in the brokerage area of the Bank from the teller and customer service areas and to protect Bank employees like me from Bank pressure. I believe that the sale of uninsured investment products should be widely available to the customer, but I think that these sales people need to be clearly identified as separate from the regular Bank staff. Also, it is important that persons who sell uninsured investment products be thoroughly trained in all areas of investments. Further, investment advisors should have a full range of investment products to offer the customer without being penalized, either financially or in terms of a career status, for selling something other than a proprietary mutual fund. I think the focus should return to what is best for the customer and not what is best for the Bank.

I believe that it is also important for securities sales staff to be doing investment advisory work on a full-time basis. The Bank employees have so many obligations and duties and so many other things they must do during the day that the Bank is asking too much of them. The Bank employees do not have time to devote to securities customers; especially, not enough time to explain a securities transaction that the Bank employee does not even understand. The present system penalizes both Bank employees and brokers for taking the time to consider the objectives, desires and best interests of the customer by spending a lot of time with them to discuss these transactions. Almost all Bank customers, including most of the elderly, simply do not understand mutual funds and these people should have everything explained to them in great detail before an investment decision is made. As the system stands, the Bank employees and brokers are required to sell what they are told to sell and are penalized when they fail to do so. This atmosphere does not foster consideration for the Bank customer and, in fact, negates it.

Working in Florida, the majority of my customers were 55 years of age or older and they are accustomed to doing their financial transactions in the Bank. They have, for the most part, a good relationship with the Bank and they trust their bankers. The banks are capitalizing on that relationship and exploiting the trust of these elderly customers. In almost all cases, these people will do whatever their banker recommends. Many of these people are lonely and their relationship with their banker is much more than a business relationship. In fact, most would call it a friendship. Not only do these elderly customers enjoy the social interaction with their Bank, they are kind and trusting and want to help the banker with his or her job as well. Also, the elderly bank population of Florida clearly has a majority of the Certificate of Deposit holdings. As a result, these people are targeted by the Bank; the fact that they have large CD holdings is circulated throughout the Bank and Bank employees are told to solicit the transfer of those monies into proprietary mutual funds. What's even worst is that CD rates have dropped to such a low point that they are not out performing inflation. At a time when the elderly customers' incomes have dropped to an all-time low, they are in desperate need of something that will make them a little bit more money to live on. Therefore, the banks have recognized that these people are desperate and can be easily lured out of their insured, secured investment with the promise of a higher current income. What's so sad is that these people, if serviced by a qualified, unbiased investment professional, could be provided with an appropriate investment mix with the potential to increase their return without undue risk to their principal. Instead, they are exploited by the Bank and tricked into placing their money in an uninsured risky investment, often times without a track record, for the sole purpose of improving the Bank's bottom line.

In closing, I would simply say that this problem boils down to one cause --- greed. The banks could provide their customers with an incredible level of service and still make a very good profit. The Bank has the opportunity, and I believe the duty, to provide its customers with a full range of financial services based upon the needs and desires of each customer. In doing so, the banks would make money and would also foster incredible loyalty from their customers. Instead, the banks have chosen to focus on creating a system whereby they can maximize profits without consideration for the customer. In the short term, this will greatly increase the profits but the long-term effects will be devastating. People will learn not to trust the banks but, unfortunately, many people will be severely financially damaged while learning that lesson. And elderly people are at a time in their life when they cannot afford to learn the lesson. And, sadly, some elderly persons will not live long enough to recoup the losses caused by this system. The banks need to focus on the individual needs of their customers and not on how much money the Bank can make from them. The Bank customers, especially the elderly, need to rely upon the Bank and need to be able to trust the Bank to do what is best for them. Instead, the banks are intentionally confusing their customers into purchasing uninsured investment products which the customers believe are accounts of, or are somehow guaranteed by, the Bank. I believe that my job is to provide the very best investment advice I can to my client without focusing on my personal pecuniary or professional gain. I do not believe that anyone can accomplish this goal within the systems which have been created by the banks.

BRANCH
LICENSING

Investor Questionnaire

Please take a few minutes to answer the questions below. Your answers will help us determine the best investment choices for you.

1. Please select the letter which best describes your knowledge of investments:

   A. I know *very little* about the stock and bond markets and have generally limited my investing to money market funds and bank deposits.

   B. I have a *basic understanding* of the stock and bond markets. I have owned stocks or bonds or mutual funds investing in stocks or bonds. I usually make investment decisions on the advice of a financial adviser, relative, or friend.

   C. I have a *good understanding* of the stock and bond markets and use advice from others as well as my own opinion in making investment decisions.

   D. I am an *experienced investor* in stocks and bonds and usually rely on my own judgments in making investment decisions.

2. Most investors define risk as the possibility of losing money on an investment. In general, the higher the risk, the higher the potential return. On the other hand, the lower the risk, the lower the potential return. Using this definition, select the investment objective which is **most appealing** to you by placing an M in the box. Select the investment objective which is **least appealing** by placing an L in the box.

   ☐ *Preservation of Assets:* I am willing to accept low or modest returns on my investment if I believe there is little risk of losing money. I don't care if my returns don't beat the inflation rate.

   ☐ *Income:* I am interested in a good level of current income from my investments. I am willing to accept that my investments will fluctuate in value, and there is a possibility that I could lose money. Growth of my investment is less important to me.

   ☐ *Growth:* I am interested in long term growth of my investment. Because I don't expect to use my money over the next five years, I can tolerate the risk of fluctuations in value and the possibility of loss if I believe there is a possibility my investment returns may be superior to less risky investments.

   ☐ *Growth and Income:* I am interested in a balance between growth of my investment and current income. I can accept some risk that my investments will fluctuate in value and that I could lose money.

3. It is very difficult for me to save money on a regular basis. ☐ YES ☐ NO

4. I depend on the income from my savings and investments to pay for much of my day-to-day living expenses. ☐ YES ☐ NO

5. Select the letter which best describes your time horizon for achieving your investment objectives:

   A. I am investing primarily to satisfy long term goals (*ten years or more*), such as retirement or a child's education.

   B. I am investing primarily for the intermediate term (*5 to 10 years*).

   C. I have a relatively short time horizon for my investments (*3 to 5 years*).

   D. I have a very short horizon for my investments (*3 years or less*).

Investor Questionnaire continued

6. In case of my death, disability or other emergency, I probably have enough insurance and readily available funds to take care of my family for at least a year. ☐ YES ☐ NO

7. Over the next 5 to 7 years I expect my family's income will: ☐ DECREASE ☐ INCREASE or stay about the same

8. My top tax bracket is: ☐ 15% ☐ 28% ☐ 31% ☐ 36% ☐ Other ☐ Don't Know

9. Which letter below best describes your age and the number of dependents (excluding yourself) in your family?

DEPENDENTS	AGE			
	Under 35	35 to 49	50 to 65	Over 65
0	A	B	C	D
1 – 2	E	F	G	H
3 – 4	I	J	K	L
5 +	M	N	O	P

10. Which letter below best describes your annual household income and the value of your financial assets? *Household income* includes salaries, interest and dividends, income from businesses and investments, and Social Security. *Financial Assets* include checking and savings, CDs, money market accounts, stocks, bonds, mutual funds, and retirement accounts.

FINANCIAL ASSETS	ANNUAL HOUSEHOLD INCOME			
	Under $25,000	$25,000 to $49,999	$50,000 to $100,000	Over $100,000
Under $25,000	a	b	c	d
$25,000 to $99,999	e	f	g	h
$100,000 to $500,000	i	j	k	l
Over $500,000	m	n	o	p

S[illegible]

No one investment — or even group of investments — is right for everyone. The mix of investments you choose for your portfolio should be based on your financial objectives, the years you have to achieve them, your current financial situation, your financial expertise and your tolerance for risk.

Here are four sample investment portfolios designed as guidelines for a variety of investors. Your specific investment portfolio, which reflects your individual needs and objectives, may differ from the sample portfolios.

[illegible] PRESERVA[illegible]

GROWTH & INCOME

INCOME

GROWTH

LIQUID	FIXED INCOME	STOCKS & OTHER
Checking & Savings	*CDs over one year*	*Stocks*
Money Market Deposit Accounts	*Intermediate Bond Funds*	*Stock Funds*
Certificates of Deposit	*Long-Term Bond Funds*	*Balanced Mutual Funds*
Money Market Funds	*Tax Deferred Annuities*	*Convertible Bond Funds*
Tax-Free Money Market Funds	*Municipal Bonds & Funds*	*Convertible Bonds & Preferred Stock*
	U.S. Government Bond Funds	
	Bonds & Notes	

THE FAMILY OF FUNDS

FUND	INVESTMENT	INVESTMENT OBJECTIVE	PORTFOLIO PROFILE	
• **Value Fund**	U.S. common stocks	Growth	Growth Potential	More Aggressive
• **Balanced Fund**	U.S. common stocks and bonds	Strategic growth and income	Growth and Income Potential	
• **Utility Fund**	Utility stocks and bonds	High current income and moderate capital appreciation	Income and Growth Potential	
• **U.S. Government Fund**	U.S. government and agency obligations	High current income with stability of principal	Income Potential	Moderate
• **State Municipal Bond Funds: Florida, Georgia, North Carolina, South Carolina, Virginia**	Municipal government debt obligations of its respective state	Tax-free income for residents of its respective state†		
• **High Grade Tax Free Fund**	Insured municipal debt obligations	Tax-free income†		
• **Fixed Income Fund**	U.S. government and corporate debt securities	Stability and income with moderate growth		
• **Money Market Fund**	U.S. government securities and short-term corporate obligations	Maximum current income with low principal risk*	Safety Potential	More Conservative
• **Tax Free Money Market Fund**	Short-term municipal obligations	Maximum federally tax-free income with low principal risk*†		
• **Treasury Money Market Fund**	Short-term U.S. government securities	Maximum current income with low principal risk*		

* Money market funds seek to maintain a stable net asset value of $1.00 per share. There is no assurance that they will be able to do so. An investment in mutual funds is neither insured nor guaranteed by the U.S. government.

** Such insurance pertains only to the timely payment of principal and interest of the securities in the Fund's portfolio and does not protect against market loss. Please see the prospectus, which more fully describes the terms of the insurance

† Income may be subject to the federal alternative minimum tax and state and local taxes

For more complete information on any of the Funds listed, please call 1-800-326-3241 for a prospectus which includes details on charges and expenses Read it carefully before investing or sending money

SUCCESSFUL PIC INTERVIEW
July 1994

MICHELLE , Charlotte, NC

Michelle grossed $69,351 in June and has $249,851 year to date. $55,494 of her June production was annuity business and $7,516 came from Branch Licensing. I asked Michelle to tell me the keys to her success. Her annuity presentation is enclosed for all non-FL PICs' use.

Michelle's Response: "I attribute any success I have to the good relationship I have with my branches. I spend a lot of time with my team, both licensed and unlicensed bankers. I make it fun for them. One of the ways I make it fun is by running contests, that I coincidentally fund out of my own pocket. I had a contest for the branch that sets the most appointments. I joined the winning branch in a "Night on the town". Another successful referral contest I funded involved $100 cash and gift certificates. One ticket was earned for making a certain number of referrals then put in the pot for a drawing. My bankers are my friends as well as business associates. I am proud to say they take ownership in the fact that if I don't sell, I don't get paid and vice versa. That's why I refer a lot of bank products to them.

My team and I are constantly discussing how to get more appointments. I E-Mail them constantly and don't feel that I can over communicate with them. We make lots of joint calls which has really increased their confidence in selling business themselves and making referrals to me.

As far as why so much annuity business, it is the product that sells right now in my market. I find many of the bank customers in this territory to be uncomfortable with securities, but if they would just open their mind for me to describe the features and benefits of a fixed rate annuity, many see it as an attractive investment. I believe you must be comfortable with the annuity product, know how to sell it, and know how to make it work for the customer. I ask my bankers to be sure and refer every customer who seems even remotely dissatisfied with their current investment, to me. I find that many times I can not only calm them down but convince them now is the time to add to their positions. But if they are determined to cash in their investment, I find that many times they view an annuity as an attractive alternative.

SUCCESSFUL PIC INTERVIEW
July 1994

JOE , Atlanta, GA

In June Joe grossed $47,371, $39,163 of which was in annuities. I asked Joe to tell me what is working for him?

Joe's Response: "Keeping a high level of activity and making it fun for the branches are the keys to my success. I do everything possible to have five appointments scheduled every day. By Friday afternoon I want to have at least 10 appointments scheduled for the following week. With five appointments a day it takes the pressure off my having to sell everyone who walks into my office.

Call nights have caused my last two months production to be the best ever.

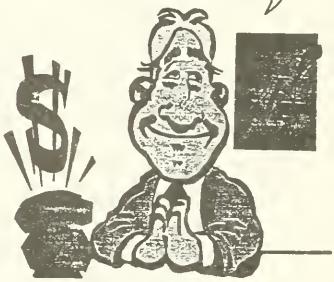
I cross sell a lot of bank products, CAP accounts in particular. My branch teammates know that I am working hard every month to help them reach their goals and that causes them to help me reach mine.

FUNDS

The
Proprietary Funds Group
will proudly sponsor the
July 19th
Blitz Night

Unimaginable Wealth!
Fabulous prizes!

PICs
PIC MGRs
CBMs
LBEs



All PICs, PIC Managers and CBMs (LBEs should listen in with their PICs or CBMs) are invited to listen in to a special conference call

Date: July 19, 1994
Time: 4:00 pm (for approximately 10 minutes)
Phone: 800/850-
Speaker: Bill , Director of Mutual Funds
Subject: Special awards and prizes

Senator PRYOR. Thank you. We're going to have some questions for you in just a moment.

Ms. Hovis, we thank you for coming this morning.

STATEMENT OF CATHERINE B. HOVIS, BROKER, TAMPA, FL

Ms. HOVIS. Thank you, Senators. I'm really both personally and professionally very pleased to be here and tell you a story that I think is of the utmost importance.

When we were discussing with your Committee members and were in the interviewing process, I asked them if they can hold these hearings as quickly as possible, because what I believe is, fortunately, maybe the folks in Montana have not yet experienced this, but what you may hear today is very likely the tip of the iceberg.

I started as a branch manager for the bank I was employed with in 1989, and at that time, we had a securities arm. It was separate from the bank, it was in a separate location, and there were no incentives, as a manager for that bank, to make referrals. We knew it simply was there, should a customer request it. And, again, like Laura, I believe that the banks should have that available.

But I've been through the metamorphosis of the greed that has happened, and we all realize that customers with very low interest rates, especially the elderly on fixed incomes, when their CDs went from 7 or 8 percent to 2 or 3, they had no choice but to seek alternative investments. So the service was there. But because of the greed that ensued, the banks began marketing their own mutual funds and made money—a lot of money—off of doing that.

My first chart that is shown shows a business plan of a bank, wherein the products were available to the customers, but it's very obvious that the green is—in the business plan, that is the amount of internal mutual funds that were expected to be sold.

I will caution you that as you look at the figures, if you do look closely, they don't agree. Some of the percentages are not correct, so there may be some confusion, but I think it's more important that we see that this bank really wanted internal mutual funds to be sold.

The next chart that I have is a contest for a bank product. Now, this is a contest for the managers of the brokerage firm to really push the brokers to sell the bank proprietary products. There were cash incentives paid to managers of the securities arm to ask every broker to participate. There was a huge amount of pressure placed upon the brokers to sell the bank funds. And I will have you note that the term "Government"—it's a trust.

The next chart is a prepared script for calling bank customers. I will bring a few things to your attention. The bank went to the customers and asked them what they were looking for. First, it's Government quality, that the account is managed by the bank trust company and has been managing money since 1874. The second part says that the bank trust was designed as an investment account specifically to meet the needs of our customers. They focused on safety. This product includes derivatives. They have predictability and yield. Again, most of your money would be placed without losing sight of your priority, which is safety, and, again,

Senators, this product did include derivatives, we have since learned.

The next display went to bank employees stressing how essential referrals were to the brokerage arm. This is notifying the bank employees that the representative is available, and if we look at the third asterisk from the bottom, that the bank offers a wide range of investment services. Finally, it says, "Would you like assistance in preparing for a secure retirement?" You have to remember, caveat emptor is important, but if we're starting from the beginning point of a bank employee and the confusion ensues from that point, the customer believes it's the bank.

As a professional broker, I did everything I could, I believe, to separate that line, but very often the elderly remember the first point of sale. The fact that they were told it was a Government investment, the fact that they were told that it was a certain interest rate, that's what they remember.

Senator PRYOR. Pardon me. I think one of the more significant notations there is the little instruction right at the very bottom in small print, which reads, "For internal use only. Not for distribution to the public." So this is for the bank employees only.

Ms. HOVIS. This is for the bank employees.

Senator PRYOR. Thank you.

Ms. HOVIS. Thank you for asking.

The next one I believe is very important, especially as it pertains to the State of Florida, where we do have current regulations regarding customer confidentiality. This is a customer referral checklist. Now, your mother walks into the bank and has worked with that banker for 10 years and trusts that banker. The banker is now being incented to refer and look for things. Did your mother just receive an inheritance? Well, that banker is giving your mother's name to the brokerage firm without your mother's knowledge, because she just placed a large check.

The fourth note down is dividend checks from other banks or other firms. That's confidential, you've made a deposit, but it's being circulated throughout the bank to other divisions. The customer is concerned about having quick access to his or her investment at the bank.

And, finally, and I think most important, is the customer has a very high account balance or is over the FDIC insurance limit. It is known that if you made a large deposit at the bank, within hours you would be called by a broker of the bank and would be asked about investing those funds. The information is freely circulated. Not just this, but also mortgage applications, et cetera, safety deposit box lists.

My next exhibit I think is very important—yes, Senator?

Senator COHEN. Just one question. You said "a broker of the bank." Were they bank employees?

Ms. HOVIS. No. The brokers were actually—we have gone through many changes in the banking industry through mergers, et cetera. We were under bank retirement, but we were considered employees of the subsidiary of the bank, and there was confusion as to names of the companies and whatnot that we believe added to that. Ultimately, we were not employees of the bank.

This I think is very important in regard to the regulations that the OCC had placed upon commission sharing. Now, I'm going to try to explain this as easy as I can. A broker in this last exhibit had a gross commission of approximately $47,000. You will look at a referral adjustment of $1,951. That came out of the broker's gross commission and went back to the bank employees. Gentlemen, bank employees don't make a lot of money. They also could make almost the same amount of money by referring products. If you have an employee who's under any duress financially, possibly a single mother on a low income, they made a lot of referrals to the bank and maybe did things that they shouldn't have done due to financial needs, and we paid substantial amounts of moneys to bank employees.

I'd like you to note that this is dated December 1993, and the moving target that the banks may try to tell you is that "We don't do this anymore." Indeed, they don't do it in the same nature. They do it through a point system, wherein the points go into a pool of money and the bank employees ultimately could sell nothing but securities referrals and still receive a substantial amount of money or prizes or trips or gifts. So I bring that to your attention. I think it's important that we learn that to abide by the letter of the law, you cannot disguise the law, and it ultimately is being continued to be done, just in a different manner.

Once again, I thank you for the opportunity to speak here, and I hope that each of you take our testimony that we've put into the record and have an opportunity to review that.

Thank you.

[The prepared statement of Ms. Hovis follows:]

TESTIMONY OF CATHERINE B. HOVIS

SENATE SPECIAL COMMITTEE ON AGING

"Uninsured Bank Products: Risky Business for Seniors?"

September 29, 1994

Senator Pryor deserves the thanks of retired citizens for bringing this matter to public attention. Senator Pryor recognizes the importance of hearings such as these, as does Senator Cohen. Both personally and professionally, I appreciate being invited here today and I appreciate the interest of both Chairman Pryor and Senator Cohen.

My name is Catherine B. Hovis and I have been licensed as a Series 7 broker since 1991. I am a single mother and I currently reside in Tampa, Florida. I spent five years working for banks and bank brokerages but I decided that I had to leave in June of this year. I now work for a securities broker in Sarasota, Florida.

I was a Branch Manager of a bank in 1989. In 1991, I was asked to get a Series 7 license so that I could work within the Bank's brokerage arm. In 1992, the Bank where I worked was bought out by a larger bank which controlled the operations until I resigned or was forced out on June 28, 1994. Having began my career as a Branch Manager of the Bank, I have really seen the metamorphosis occur and the Bank's complete greed in changing the way banking is done. When I was a Branch Manager, I never made a securities referral and I was considered one of the most successful Branch Manager in Hillsborough County, Florida. We had a brokerage arm of the Bank but they were in a separate location and there was no pressure to sell securities. During the early 1990s, things began to change. That's when the pressure began to sell proprietary Bank mutual funds. Before the takeover of our Bank, we did have proprietary mutual funds but the names were completely dissimilar to that of the Bank. When the new Bank took over, they changed the name of the funds to be the same as the Bank's name. This was done solely to create the illusion that these funds were connected with the Bank. I know that customers believed that these funds were a part of the Bank and guaranteed by the Bank, and that is what the Bank wanted customers to believe. Also, Customer Service Representatives and brokers were given sales goals and quotas and required to push proprietary mutual funds in order to have their job performance termed satisfactory. The Bank began

circulating information about customers' accounts and maturity dates of Certificates of Deposit in an attempt to aid brokers and Bank employees in luring depository customers into the purchase of uninsured, proprietary mutual funds. This had a special impact on the elderly customers of the Bank because they hold a large number of Certificates of Deposit. These lists provided Bank personnel with the knowledge of what customers had CDs and upon what dates the CDs would mature. This information was used to directly solicit the customers either by telephone or when they came in to do their banking.

I had worked hard to build a client base and to gain the trust of the customers I had. I was responsible for these people and I truly believed that a broker's relationship with her client is one for life. The Bank created a system to provide a greater amount of referrals of depository Bank customers but, at the same time, completely restricted my ability to provide objective investment advice to these customers.

The internal pressures and sales quotas were difficult enough to deal with but, in addition, the Bank instituted a financial incentive, and disincentive, program under which all Bank employees and brokers had no choice but to sell proprietary funds. If a Bank employee referred a depository customer to the brokerage, he or she would get cash, prizes or other incentives after the sale. The incentives changed from time to time, but the Bank employee was only rewarded if he or she made referrals to the brokerage. Meanwhile, the brokers were placed on a payout grid which provided a low payout even for the sale of proprietary mutual funds and very low or no payout for other investment vehicles. In order to make a minimum amount of money, the broker had no choice but to sell proprietary mutual funds to the customer. I tried to be a team player but I realized that many of these funds had no track record and were not suitable for the customers. Whenever I made these concerns known, I was told that I was not going to be a valuable part of the Bank if I refused to go along with these requirements. Also, I had to make enough money to feed my child. Selling proprietary funds was the only way I could earn a living in this environment. I accept full responsibility for going along with the Bank's demands; but, I realized they were wrong.

In a short time, I could see that this system was not going to work out because it simply ignored the wishes and needs of the customers. I could not bring myself to take my Bank customers who trusted me and put them into investments with no track records simply because the Bank would make more money. Also, during this time, the Bank was adding new brokers whose only experience was a two week training session on how to sell the Bank's proprietary mutual funds. These brokers were brought in and were placed at Bank branches I had previously serviced. These new and inexperienced brokers were operating under severe financial duress to push proprietary products and did not have the experience or training to know what other types of investments would be best for the customer. Again, when I objected to my customers being subjected to inexperienced brokers whose sole agenda was to push proprietary mutual funds, I was told that it might be a good idea for me to find another place to work. Finally, on June 28, 1994, I resigned as I could no longer stomach what was going on. The system simply has to be changed.

I think one of the biggest problems in letting bank employees start the referral process, especially with elderly customers, is that the consumer will tend to remember only the first things they hear. For example, the consumer walks in and sees a Customer Service Representative whom they have dealt with on numerous occasions with traditional banking transactions. The same Customer Service Representative now tells the consumer that "the Bank has an account which will pay 6% for six years. Would you be interested in that?" The customer has heard this from a Bank employee who has taken care of them and whom they trust. That initial contact is what the consumer remembers even if there may be subsequent discussions about the product. Also, the scripts and terms which the Bank employees are told to use are intentionally designed to confuse the customer. Terms like "government investment", "penalty for early withdrawal" or citing the name of a fund which is the same as the Bank's name all tend to confuse the customer into believing that somehow what they are purchasing is backed by, guaranteed by or insured by the Bank and/or the government. The Bank intentionally fosters this confusion and capitalizes upon it. Indeed, the names of the mutual funds were changed to exploit this confusion. Again, what results is a Bank teller selling securities so that she may increase her income and her prestige with the Bank and, while this is going on, no one is taking into consideration

the suitability of the mutual fund which is being sold to the customer. Many funds, especially new issues of the Bank, were not particularly good funds and had absolutely no track record. The only thing to recommend these funds was the fact that brokers were required to sell a certain dollar amount of the funds in order to avoid reprimand. And Bank employees continued to have the number of referrals they are required to make increased.

I believe that another central problem is the location of the securities sale. These people have come to the Bank and are in the Bank lobby. The lobby is full of information about uninsured, proprietary mutual funds that have a name identical to that of the Bank. Also, the lobby is full of FDIC-insured signs and Bank logos. The customers cannot possibly understand that these funds are not somehow backed by the Bank. As I stated before, when we first began the brokerage in our Bank in the late '80s, it was in a separate location and there was no chance that a customer would be confused. Now, a customer is sold securities at the same desk where they open a checking account and there is no way that you can expect a consumer, especially an elderly person who has never invested with a brokerage before, to understand the difference. I once heard someone say that he believed it was the consumer's duty to be educated about these investments and I could not disagree with that statement more. Sure, I believe that we should all know more about our finances; but, I do not believe that banks should be allowed to place all responsibility for education upon the consumer. When you want legal advice, you go to a lawyer. If a lawyer tried to say you should have known the law before you came to him, nobody would think that made any sense. That's why you went to the lawyer, so he could advise you about the law. That is the exact reason why people go to a bank, to receive sound financial advice. Selling proprietary mutual funds in order to increase the profits of the Bank without regard to the customer's needs or desires is clearly a breach of the duty that banks owe to their customers. A broker must be free of economic and internal employment constraints when giving investment advice and the banks have established and perpetuated this system which completely forbids such independence.

I strongly believe that there is a need for investment advisory services, especially among the elderly, today. Currently, traditional depository accounts are not producing a yield sufficient to provide these people with enough money to live and that's exactly what most elderly people count on this money for. Unfortunately, instead of answering the needs of these customers, the Bank chose to exploit them. Instead of accepting the responsibility to their customers to provide independent and suitable financial advice, the banks have chosen to use the customer's trust to their advantage by selling proprietary mutual funds which, although they do not always perform badly, are rarely the most suitable investment for the Bank customer, especially the elderly. The Bank is simply greedy and wants to make money on every part of the transaction.

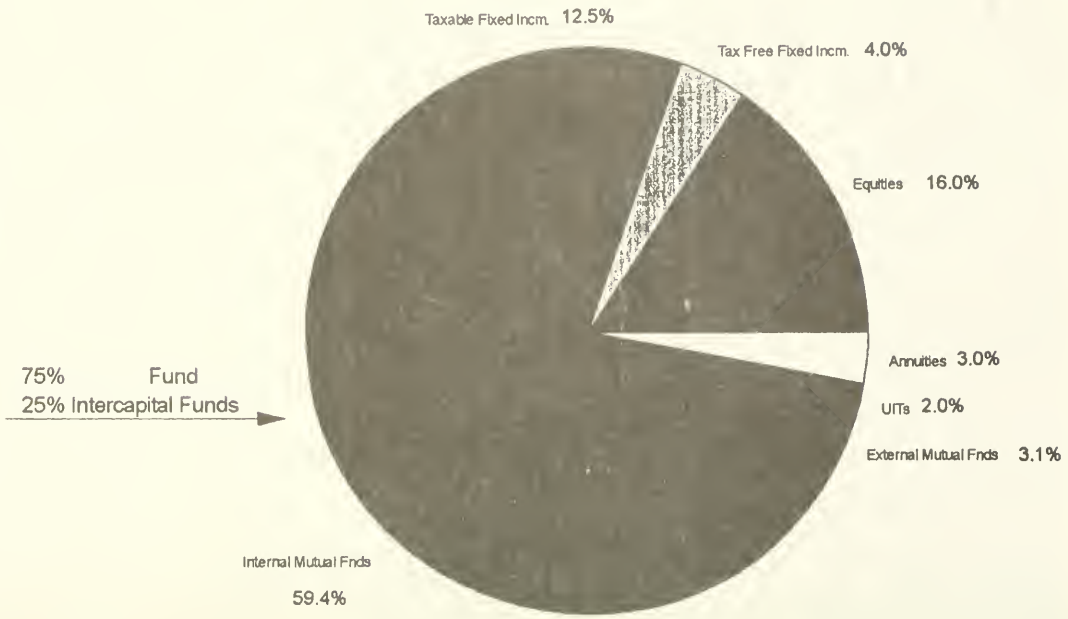
The Bank employee receives a referral fee and the employees know that the only way to make a decent living and keep the Bank happy is to refer securities customers. The Bank then makes money off each securities transaction and, rather than be satisfied by the commission generated from any securities sales, the Bank has chosen to mandate that all sales be made into proprietary mutual funds so that the Bank can not only get a higher commission but also can receive a contingent deferred sales charge or CDSC if the customer leaves the investment within, usually, four or five years. Also, the Bank receives management fees from controlling the mutual funds. The Bank's focus is on generating income and not on taking care of its customers.

The bottom line is that the banks have not exhibited the desire nor the courage to change the way they are doing business. Someone needs to stand up and say that this system is wrong and that, while the ability of a bank to offer brokerages services to its customer may be, in theory, a good thing, the way that banks have implemented the sales of uninsured investment products is simply wrong. Instead of trying to eliminate customer confusion, the Bank enhanced it. Instead of accepting its responsibility to provide investment advice to, and badly needed assistance for, its customers, the Bank decided to develop a system where only Bank proprietary mutual funds would be offered; creating the maximum profit for the Bank along with the maximum risk to the customer.

Instead of training the securities brokers to provide an outstanding level of service to the customers, the Bank intentionally recruited inexperienced brokers whose only training was in how to sell proprietary funds. Clearly, providing a full range of investment services at the Bank can be both a noble and profitable proposition; unfortunately, the Bank has chosen to ignore its duties and responsibilities and has focused on its ability to take advantage of the situation.

It takes a true leader to stand up and say that something is wrong and that it needs to be fixed. It takes courage to admit that the current system is not working and even more courage to admit that what was done to these Bank customers was wrong. The banks are simply telling the customers one thing and doing another. The banks are telling the regulators and the Congress that they are doing one thing while they are really doing another. It is time for someone to look at what the banks are doing and realize the inconsistencies. The banks are creating the illusion of safety and security and are exploiting that illusion to the detriment of their customers. And, as more banks see the amazing profit potential of this illusion, I am afraid that this problem will only grow larger and larger. Someone must have the courage to say enough is enough.

Securities Proposed Year 1 Product Mix



Fund Mix 90% Internal / 10% External

- For Internal Use Only -

Proper disclosure must accompany each and every product presentation and recommendation. Account Executives have a responsibility to assure that advice and specific product recommendations are both appropriate and suitable for customers

Government Income Term Trust 2004

◆ ◆ *Fast Start* ◆ ◆

- Day 1, January 25 -

★ ★ ★ Branch Manager Contest ★ ★ ★

! ! ! Top 5 Branch Managers In Sales As A Percentage of Goal On First Day of Ticketing (January 25, 1994)! ! !

1st in Sales ☞ $1000
2nd in Sales ☞ $800
3rd in Sales ☞ $600
4th in Sales ☞ $400
5th in Sales ☞ $200

Qualifiers: 50% of your Account Executives must have a minimum of $20,000 in sales with a minimum of 8 brokers or 100% participating.

- 4 Day, January 25, 26, 27 & 28 -

★ ★ ★ Branch Manager Contest ★ ★ ★

! ! ! Top 5 Branch Managers In Sales As A Percentage of Goal On the First Four Days of Ticketing (Tuesday - Friday)! ! !

1st in Sales ☞ $1000
2nd in Sales ☞ $800
3rd in Sales ☞ $600
4th in Sales ☞ $400
5th in Sales ☞ $200

Qualifiers: 50% of your Account Executives must have a minimum of $60,000 in sales with a minimum of 10 brokers or 100% participating.

A. PRESENTATION

(Establish customer's goals and objectives)

Bank went to customers and asked them what they were looking for in an investment. Customers came back with three key components:

1. Government Quality - highest credit quality
2. Fixed Maturity - something they can count on seeing again.
3. Increased Rate Return - because interest rates are so low today.

- This account is managed by Bank Trust Department.
- Managed $ since 1874.
- Look after $160B for customers in the past to get this type of management through Trust - you had to be Texas A&M, Heart Association, or have the wealth of Ross Perot.
- Bank has made this expertise available to you, our retail customers.

Bank Trust designed an investment account specifically to meet our customers needs. We focused on:

SAFETY, by using government bonds and AAA rated issues.

PREDICTABILITY, account is managed to return your principal in 10 years.

YIELD, with interest rates so low it allows you to get the most out of your money with out losing sight of your priority, safety. We anticipate a yield of 6 1/2-7%.

Making referrals can be easy. The following lead-ins can help you decide which customers may be ideal referral candidates for [redacted] Securities. Remember, you are an important part of the referral process and we appreciate your efforts!

REFERRALS ARE KEY!

* Aren't you tired of paying too much in taxes?

* Would you be interested in lowering your total tax liability?

* Were you aware that a representative is available to provide a financial consultation?

* Are your interested in earning more income?

* Many priority customers, like yourself, work with our investment representatives. May I introduce you to him/her?

* Bank offers a wide range of investment services. If you'd like, I can ask a Securities representative to call and arrange a meeting.

* Are you interested in tax savings alternatives from our investment area?

* Would you like assistance in preparing for a secure retirement?

COMPLIMENTS OF:

[redacted] FUND [redacted]

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CUSTOMER REFERRAL CHECKLIST

Have you seen any of the following situations? They could be positive hints for referring customers to your [redacted] Securities Investment Representative.

- ☑ Customer asks for investment information
- ☑ Customer asks for information on IRA's, IRA Rollovers, or pension funds
- ☑ Customer has coupons from bonds, or has bonds that have been called
- ☑ Customer has dividend checks from stocks, bonds, or other brokerage firms
- ☑ Customer sells home, land, car or business
- ☑ Customer has change in lifestyle: move, retirement, inheritance
- ☑ Customer says taxes are too high
- ☑ Customer concerned about having quick access to his/her investment at bank
- ☑ Customer says another institution is paying higher yields on savings or investment products
- ☑ Customer has CDs with other institutions
- ☑ Customer requests a signature guarantee on a stock certificate
- ☑ Customer has a very high account balance or is over FDIC insurance limit

Securities

Company

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IO INCENTIVE PAYMENT REPORT
FOR DECEMBER PRODUCTION

SALES CREDITS	47,059.76
<LESS>: ERRORS CHARGED GROSS	0.00
PLUS: CANCEL AND REBILL CHARGES	0.00
ADJUSTED SALES CREDITS	47,059.76
<LESS>: NET REFERRAL ADJUSTMENT	(1,951.75)
NET SALES CREDITS	45,108.01
RATE	35%
SALES CREDIT INCENTIVE	15,787.80
PLUS <LESS>: SALARY/DRAW	(2,724.58)
TRANSITION BONUS	0.00
ERRORS AND LOSSES	0.00
PRIOR MONTH NEGATIVE CARRYFORWARD	0.00
DECEMBER 1992 MONTHLY INCENTIVE (NEGATIVE CARRYFORWARD)	13,063.22
TOTAL GROSS PAYMENT ON JANUARY 31, 1993	13,063.22

Senator PRYOR. Thank you, Ms. Hovis. All of your written testimony will be made a part of this record, and we're going to start a little series of questions here, if we could, for this panel.

Let me, if I could, go to Ms. DeMint and ask, if you had known that these funds were not insured by the bank in which you were investing, would you have at that time consented to having your money invested in such a product?

Ms. DEMINT. Absolutely not, sir. Had I known that I was dealing with somebody other than the actual bank itself, some kind of brokerage firm, there would be no way. I truly believed I was buying Government bonds that were like savings bonds, that this is what I was purchasing.

Senator PRYOR. Now, you actually trusted the bank to the extent that you felt like the bank or the FDIC was insuring these particular funds.

Ms. DEMINT. This fellow, this representative, told me the only thing that I could lose was if every bank in the entire United States of America went broke. That would be the only way I could lose anything at all.

Senator PRYOR. Now, once again, describe for the Committee this individual. Was he an employee of the bank?

Ms. DEMINT. He is an employee of the securities division of the bank.

Senator PRYOR. Of the securities division.

Ms. DEMINT. He's a broker.

Senator PRYOR. And was your case referred by one of the tellers? How did you get notice of the investment?

Ms. DEMINT. To begin with, the verbal was over the phone. I spoke to them, and they said that they could give me better rates, they would have somebody from the bank call me and discuss this with me. That was when this male representative called, and I assumed that this was the bank calling me, and this was when he offered me the 6 to 7 percent for the Government bonds. I later made an appointment, and I went down to the bank itself, and that's where I discussed everything.

Senator PRYOR. Now, Mr. Wells, I read your full statement and you said that you were just a small fish or what have you and you kind of gave up your fight against the bank to retrieve your funds and put them into an insured investment. Tell us a little bit about how the bank treated you there.

Mr. WELLS. When I went back, and as I said, I couldn't find either of the people that I had dealt with, it was just like, you know, "You're sort of making a nuisance of yourself, and there's nothing we can do for you," and I knew if I started raising a ruckus, they were going to throw me out or, worse, I would lose money probably getting myself out of trouble. So figuring the amount of money, I said I would just go ahead and take the loss and forget about it, which I had decided to do.

Senator COHEN. Have you changed your mind since? Are you trying to get the $500 back?

Mr. WELLS. Yes, sir. The best thing that ever happened was when I read about Ms. DeMint and when I met Attorney Alpert.

Senator PRYOR. And you got the bank's attention at that time.

Mr. WELLS. Oh, definitely so, sir. Yes, sir.

Senator PRYOR. But it took that to do it.

Mr. WELLS. It took that. Until then it was almost like a joke when I would go into the bank and try to talk to the people, because they simply just ignored me.

Senator PRYOR. Did any of your friends get into this same situation that you talked about? You said that you're kind of a knowledgeable investor.

Mr. WELLS. None of my friends got into it. As a matter of fact, because I thought I was a knowledgeable investor, I don't talk to my friends too much about it, because it doesn't show I was too smart to get taken that way.

Senator PRYOR. I bet they don't look for you anymore.

Ms. Park, you mentioned that you basically got fired from your job, and you think the reason is that I guess you kind of blew the whistle and you said, "These people are not trained to sell these securities." Is that correct?

Ms. PARK. Well, when I first began training the particular course for the bankers, one of my observations, much to my dismay, was that the course was called "Sales and Operations," and in fact, the vast majority of the 40-week course was on sales techniques and operations and virtually no information was provided to the bankers on investment theory, financial planning, or even any information on the financial market or a comparison of other products available.

Senator PRYOR. Well, do you think that the recent announcement that all bank brokers are going to be required to take the NASD exam is going to be of benefit?

Ms. PARK. I believe that that may be of some benefit, but that's only a starting point. I think that anyone who professes to be an investment advisor, counselor, broker needs to have a minimum background in investments so that they understand what it is they're recommending. For example, if a banker suggests a U.S. Government bond fund, it's important to know that those bonds are of high quality, but they also need to understand what will happen to that bond fund as interest rates change so they can adequately communicate that to the customer so the customer is in possession of the full story and can then make an informed decision.

Senator PRYOR. Now, in your testimony or perhaps the testimony of Ms. Hovis, one of the two of you made reference to, I believe, proprietary securities. What is that?

Ms. PARK. It's a generic product. It's the bank brand fund.

Senator PRYOR. Say First State Bank of whatever town, USA has a proprietary security—could you give me an example of that?

Ms. PARK. Yes. This was the proprietary mutual fund of the last bank that I worked for, U.S. Government Fund, and right on the cover it says "Generating Income for Conservative Investors," and this is a private label that my bank managed, for which they got a fee for every dollar invested in this fund on an annual basis.

Senator PRYOR. So they sort of generated their own fees.

Ms. PARK. Exactly.

Senator PRYOR. Now, is that particular fund insured by the U.S. Government or the FDIC?

Ms. PARK. No mutual fund is insured or guaranteed in any way whatsoever.

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Senator PRYOR. Was the incentive for the broker and the employee of the bank to steer potential customers to that particular fund or to buy, say, other mutual funds that are listed daily in the stock market sections of the paper?

Ms. PARK. There was tremendous pressure to sell one of the bank's family of funds. The bankers I trained were not permitted to sell anything except the bank funds. They did not get any commission dollars or any sales credit for selling anything else. For other brokers in the bank who had a license to sell a full range of products, there was tremendous incentive to sell bank products. There were contests, referrals, extra money paid, cars, trips, that sort of thing. There also were lists of each individual's production in these funds circulated throughout the bank. So even if you had a good practice selling other investment products, your name could end up being on the bottom of the list if you were not selling the bank's own funds.

Senator PRYOR. Ms. Hovis, I think you come at this a little differently than Ms. Park. You yourself were not in the bank, were you? You were an outside broker. Am I correct?

Ms. HOVIS. For the bank. Both of us worked for banks who had subsidiaries.

Senator PRYOR. Were you physically located in the bank building?

Ms. HOVIS. Yes, I was.

Senator PRYOR. In the lobby?

Ms. HOVIS. Yes.

Senator PRYOR. OK.

Ms. HOVIS. I had, when I started as a broker for the bank, six bank branches that were assigned to me, and we sat at the desks, in offices, and ultimately, through several changes, the bank now has permanent offices in each bank branch that physically can handle that. So even though they have a separate office and a small sign that we work for a different company, the consumer walks into the FDIC-insured bank. And throughout the lobby, all of the proprietary products which the bank sells are very similar to the name of the bank in color and in name, so there's a tremendous amount of confusion. The signage may exist, but it's under the umbrella of the FDIC-insured bank.

Senator PRYOR. I see.

I have a few more questions left, but I'm going to yield to my friend and colleague, Senator Cohen.

Senator COHEN. Thank you, Mr. Chairman.

Ms. DeMint, were you ever given or sent a prospectus?

Ms. DEMINT. No, sir.

Senator COHEN. Were you ever told there would be fees or other types of charges?

Ms. DEMINT. No, sir. The only thing that I was told was that if I withdrew this before the 5-year maturity date, that there would be a penalty for early withdrawal.

Senator COHEN. Mr. Wells, you were told the same thing, except I think you testified you did receive a prospectus.

Mr. WELLS. Yes, sir. I received the prospectus after my check was mailed to the bank.

Senator COHEN. And did you understand at the time you made the transaction that there would be fees and charges and other types of assessments?

Mr. WELLS. No, sir. When I made the transaction, the only thing I knew was that I was given a bank account that was going to pay me 5 percent for 5 years, with the only penalty if I withdrew prior to the 5 years.

Senator COHEN. Let me ask Ms. Park and Ms. Hovis, what is a security?

Ms. HOVIS. Go ahead, Laura.

Ms. PARK. Thank you, Kate.

A security is basically an investment. If I define a stock, that is ownership in America's corporations. A bond is a security. It is a debt instrument.

Senator COHEN. What is secure about it?

Ms. PARK. The security comes through diversification and time for the security to do its job.

Senator COHEN. Let me ask you, government securities, are they more secure than a mutual fund?

Ms. HOVIS. It could be the same thing. Government securities can be a mutual fund. The confusion, if I may, ensues that the mutual fund, as a Government securities, is not insured. What the mutual fund buys may be. There may be 5-year treasuries which are guaranteed by the U.S. Government, but the mutual fund and the fluctuation of those values are not guaranteed. So the confusion is created by the dual terminology.

Ms. PARK. And I think that you've put your finger on the problem, that what might be labeled full disclosure does not mean it is clear communication and that the customer understands both the risks as well as potential benefits, why we're suggesting that they invest in our recommendations, what that might do for them. And I think that if we were providing that service so the customer could make a fully informed choice, they would do one of two things. They would either invest in mutual funds with the knowledge that they should have, or they would go back to their CDs paying the rates that FDIC-insured products pay and be satisfied with that, knowing that you get what you pay for, and if you want a greater return, you have got to take more risks.

Ms. HOVIS. I'd like to address, if I may, the fact that you recently passed legislation that requires the employees of the bank to become licensed. Just because you have a license doesn't mean that you are properly selling investments. You can take a class and get a license on rebuilding an automobile, but you can't maybe walk out there tomorrow and explain it and work with that car again. That license could be a license to steal in some ways. So it has to be utilized—a license has to be utilized in the proper environment. So I did want to address that point. There are a lot of licensed brokers out there that are not properly disclosing the types of investments they're selling.

Senator COHEN. I'd like to come back to the point that I think when we use terminology, that in itself is confusing. When you talk about investment securities, people have to understand that there's nothing secure in the sense they're going to get their money back.

They may in fact lose it all, unless we're talking about Government securities, in which the Federal Government would have to fail.

You talked, Ms. Hovis, about the misleading terms, and if you could put chart No. 2 back up—Government, income, term, trust, 2004. At the top of that it says, "Proper disclosure must accompany each and every product presentation and recommendation. Account executives have a responsibility to assure that advice and specific product recommendations are both appropriate and suitable for customers." Was that done in your bank?

Ms. HOVIS. In my opinion, no, it has not been done, because there is a very serious lack of supervision by having these, in many cases, inexperienced brokers out in bank branches with no supervision in how they are selling, and once again, it is imperative that you remember that the initial point of sale typically comes from the bank employee, then referred on to the broker. So proper disclosure may be given, but how it is given or not explained is unsupervised.

Senator COHEN. Ms. Park, what about your banks where you worked?

Ms. PARK. I would say definitely not, and it is because the bankers I was training clearly did not have the background or training to know what a suitable investment was or to be able to give a customer a clear explanation of it. They might learn one fund and make that fit every investor they came across, and so every investor might have gotten U.S. Government Fund or perhaps a utility fund. I think it was not so much the part of the bankers. I'll submit to you that they were naive. They did not really know what they were doing, except that the bank was paying and incenting their behavior, and so they didn't see a problem with writing a mutual fund ticket for $50,000 or $100,000.

Senator COHEN. Mr. Wells, Ms. DeMint, I assume that you were never counseled on what would be a suitable or appropriate investment for you depending upon your income, your assets, or other investments you might have. Was that kind of advice ever given to either one of you before you invested?

Ms. DEMINT. Not to me, sir. There was no talk of investments. I even asked him, I said, "Just give me a ballpark figure on the $60,000 of the amount of interest that I'm going to have in 5 years," and it's written on one of my receipts. He told me I would have a minimum of $75,000 out of the $60,000. Now, how could that be if I was going to lose principal?

Senator COHEN. Ms. Park, if I could ask you one other question, I think you indicated you took a series 7 license exam, that some bank employees received a series 6 license.

Ms. PARK. Yes.

Senator COHEN. Would you explain the difference to me in terms of what that would qualify the person who passed the series 7 for versus those for the series 6?

Ms. PARK. Yes; that's a good question. Series 6 allows the bank employee to sell only mutual funds, although the licensing would permit them to sell any company's mutual fund. By bank policy, they were restricted to only selling the bank's fund. Whereas with a series 7 license, that's a license to sell a full range of investment products—mutual funds, individual municipal bonds, individual

stocks, individual Government bonds—to be able to provide a full range of services.

Senator COHEN. Well, is it then in the bank's interest to hire only those who have the series 6?

Ms. PARK. Yes, sir, because they have to pay them far less than they would have to pay a series 7 licensed broker.

Senator COHEN. And they only recommend the investment in the bank's funds.

Ms. PARK. That is correct, and they also don't have to really worry about any other investment, because they're not concerned about it.

Senator COHEN. Are there situations in which those who are licensed for series 6 status breech that barrier and also make recommendations pertaining to other investments, in your experience?

Ms. PARK. Yes, I believe that there was. I believe that one of our people recommended another investment and was terminated as a result of that. Violated the licensing requirement, should have referred it to a series 7, did not do that.

Senator COHEN. OK. I yield to my colleague, Senator Burns.

Senator BURNS. Thank you very much.

I am struck by this. I think I want to pursue that we can pass all kinds of laws, licensing requirements, but we can't do anything about ethics in a financial institution. I didn't know that the bank had the freedom just to pass the information of your accounts around to everybody in the bank or that the bank was allowing that to be made public knowledge to the rest of the people of the world. Is that a common practice among all banks?

Ms. HOVIS. I can only speak for the bank that I was employed with, Senator, and it is a very common practice. Very common. We had complete access to the bank's computers.

Senator BURNS. I tried to change banks one time, but I couldn't transfer an overdraft, and they wouldn't take that.

I'm struck by this. I mean, I just can't believe it, because I happen to believe that these people here, and even me as an individual if I do business with that institution, that information is just for me and my banker and nobody else. I've always had that feeling, and I guess I'm really struck by this, and I don't know how to react to that. Because any decisions on my financial future have to be made by me, and just because a person that's in a position of confidentiality, and then he uses that to market seems like we have a terrible problem with ethics here in our banking institution.

Ms. HOVIS. We agree.

Ms. PARK. Because that was also a very widespread practice at my bank. As a matter of fact, it was exploited by the marketing department. All of the information on all of the customers is entered into a central computer. The marketing department then makes lists based on certain lists of criteria and then distributes those lists for the blitz night that we had a poster on for fabulous prizes and wealth.

Ms. HOVIS. Ms. Park and I worked for separate institutions, and having met each other because of this experience, we have really been in awe as to the similarities of two totally different banks. The institution I worked for, if you had a safety deposit box, your name was given to a broker, because it may be that you have bonds

in your box, and we can hold those bonds in safekeeping. It was a very common practice that the brokers could go to the branch manager and say, "I want a list of every account holder that has over $100,000," and they would get a printout and start to direct mail or call, or both.

Senator BURNS. That explains a lot of—out in Montana—let me just relate this little story to you—I used to work for a livestock commission company and I still order my cattle and we run large sums of money, especially this time of the year when this is the shipping time and delivery time and the other day—I'm running for re-election—a man came in and wanted to support my campaign and wanted to give me cash and he's in the sheep business up in the northern part of the State. And I can remember him coming——

Senator PRYOR. Is anyone from the Federal Election Commission here?

Senator BURNS. I know, and I'll make this very public. It doesn't make any difference, because this is the way I handled it. I couldn't take the man's money, and it broke his heart. He said, "Well, I don't understand that. They'll take my money when I buy a truck." But he came in there with cash money, and I remember that man when we used to sell his livestock he would take the check from the commission company right to the bank, get his cash, and he'd go back to the hills. I think he's got money buried all over that ranch up there. But maybe he found this out a long time ago, "By gosh, I'm going to handle my own."

I'm wondering—just going through and listening to the testimony, I don't know how to attack this problem, Mr. Chairman, because I see that it's a problem, but it's a problem that everybody knows what you're doing, what we think should be—I think Ms. DeMint, her financial condition should be her business and the business and the confidentiality of her broker or her banker, whoever she chooses to do business with. It ain't nobody else's business, and nobody else should be giving out that information. So I'm saying no matter what kind of a law we pass, what kind of ethics are we talking about here?

Senator PRYOR. We're going to be asking the second panel some of those very questions, so don't leave. I hope you'll ask that second panel some of those very questions.

Ms. PARK. I think one point we might make is that in terms of ethics, it's very important that all of us have the right to retain counsel and to get the institution's attention by taking legal action.

Senator BURNS. I don't have too much love for the legal profession, so I have real problems with that. I want to avoid them fellows if I can, or women, whichever it is. I'm going to leave that to the Chairman. But I just want to—I've got to go, because I've got to manage an appropriations on the floor, but I just want to put in that I'm just struck by the fact that all this information becomes very public on what I consider very private business.

Ms. HOVIS. Senator, before you leave, we do have documents that are in the paperwork that you've received that shows a very typical case of a customer's account balance printed up and just freely given and some notes given, and in answer to your question, I believe that there are regulations in force at this time, but they're not

enforced. We have them. We need to make sure that all the regulations that are out there are enforced. And as I mentioned, I have been told that in the State of Florida, which we represent, those regulations exist, but they have been ignored, and no one is policing that or accepting the responsibility to do so.

Senator BURNS. Well, now, let me ask another question here. If those regulations are there, whose responsibility is it to enforce them? Is it the State banking regulators?

Ms. HOVIS. Again, prior to coming today, I have spoken with several different enforcement agencies, and I have to be very candid that when the different offices, be it the SEC, the OCC, or the Florida Banking Commission were there, it seemed as if no one wanted to address it or accept responsibility. I'm just a regular person that gets up every day and goes to work. I do not understand the politics involved with this, but it was apparent, having some intelligence, that there is.

Somebody needs to accept the responsibility and have the courage to stand up and say, "We should have been doing this. Our division is responsible." I saw those three divisions literally give up, and I felt that it was a waste of time, that nobody really wanted to, I believe, for political reasons, accept the responsibility. We have policemen, but they're not policing.

Senator BURNS. Well, I never had any calls from a banker, because I've never had any money. I don't have an account large enough for them to pass on to anybody. But it just strikes me as even within the banking industry, this should be somewhere in their code of ethics that there has to be some confidentiality of a person's business and his wherewithal in that banking institution. You see, if you are assigned to one part of that bank, I don't think it's any of your business what I have in my bank account. Nothing personal.

Mr. WELLS. Sir, if I might add, please, to what you were saying, I was dealing with another institution, and I had some CDs mature. As soon as I went—it was several thousand dollars. As soon as I went there, the first thing I was told after I got my check was, "Go over and talk to the gentleman sitting there to see about investing my money," and I said, "I don't want to. I would prefer to get a CD." She said, "Well, he might could give you a good deal." But I guess this lady had to do this.

Ms. HOVIS. I believe that you'll find it possibly more prominent in the State of Florida because we have so many retirees who feel the confusion, and, again, I believe that the banks—there is a sense of greed, and that they are capitalizing upon that by not abiding by the letter of the law, and they recognize the opportunity. When you sell a proprietary mutual fund that the bank manages, the bank gets an up-front fee, the teller gets paid, the broker gets paid, and for every year that that fund remains on the books, the bank gets an annual management fee. So we're talking about a very substantial financial incentive.

You all, I'm sure, are aware of the fact that billions of dollars in the last several years, with declining interest rates, have gone out of banks into mutual funds. Now, you just think for a moment, if we are forced to sell these proprietary funds, the banks may have lost CDs, but it is fairly evident that they've made a lot more

money, and the incentive was there to do so. So the regulations, again, may exist, but the incentive was there not to enforce them.

Senator BURNS. Well, I appreciate it, and, again, Mr. Chairman, I appreciate you having this hearing today, because it's been very enlightening to me, and I appreciate your testimony. We've got to study this very carefully—I think we have to study it. I'm saying, though, that I'm not real sure we don't have the regulation. I'm not sure that a law needs to be passed. I'm thinking the banking industry has got to take a look at themselves, because we can do everything but ethics around here. I thank you, and I thank you for this time, and I thank you for your testimony.

Senator PRYOR. Senator Burns, thank you very much, and a final question or two. Do the State-chartered banks differ in their regulations versus, say, the federally chartered banks, or are the regulations the same?

Ms. HOVIS. I can't answer that question. I don't know that.

Senator PRYOR. Is this the Federal Government's role, then, or the State government's role; who is best qualified to sort of enforce this area?

Ms. HOVIS. I don't believe we can answer that question, not being attorneys and not knowing the certain laws of the banks and how each of those are——

Senator PRYOR. We're going to ask the next panel this.

Senator BURNS. You don't have to carry that yield.

Ms. HOVIS. No.

Senator PRYOR. You all might be aware that Senator Burns is an auctioneer.

AUDIENCE VOICE. That's worse than a lawyer.

Senator PRYOR. It's not as bad as a politician, though. He got out of the auctioneering business and became a politician. But he made several references to that, and I just wanted you to know a little bit about his background before he came to the U.S. Senate.

We want to thank all of our panelists this morning. You have really served a real purpose to our country, and this is going to help to educate a lot of people who are looking at investing and who might be sort of taken in or might not have full disclosure presented to them about those potential investments, and we owe you a debt of gratitude. Thank you very much.

Senator BURNS. I think the exposure will do a lot.

Senator PRYOR. I think that's true.

Thank you very much.

Senator PRYOR. We will ask our second panel to come forward. We welcome our second panel this morning. We have Denise Crawford. Denise Crawford is the Texas Securities Commissioner and Chair of the Bank Securities Activities Committee of the North American Securities Administrators Association. This organization is the national voice of some 50 State security agencies. It is responsible for investor protection and the efficient functioning of the capital markets at the grassroots level.

Our second panelist this morning is Alfred Pollard. He's the senior director for legislative affairs at the Bankers Roundtable. The roundtable represents the Nation's major banking companies, and, Mr. Pollard, from what we have heard this morning, I think that

your testimony is going to be very interesting and challenging, let's say.

Then we have Scott Galloway. He is the co-founder of Prophet Market Research and Consulting, a market research firm. The Prophet Company has done a study which is the largest syndicated study on the performance of investment representatives across investment institutes.

We welcome all three of you today. Ms. Crawford, we would ask if you would lead off.

STATEMENT OF DENISE VOIGT CRAWFORD, TEXAS SECURITIES COMMISSIONER, AND CHAIR, BANK SECURITIES ACTIVITIES COMMITTEE, NORTH AMERICAN SECURITIES ADMINISTRATORS ASSOCIATION, WASHINGTON, DC

Ms. CRAWFORD. Mr. Chairman, I appreciate very much having the opportunity to appear before your committee this morning. There's no question but that there has been an amazing number of developments in the consumer and finance areas in recent years, and most of those have been very positive. However, one of the unfortunate consequences and one with which you've been very much concerned here today has been the great deal of customer confusion, especially in the retail marketing of uninsured investment products at banks and by banks.

Today State securities regulators across the country are reporting case after case of consumer confusion. Primarily, the confusion is based upon difficulties understanding the difference between FDIC and SIPC insurance, and the risks and fees associated with mutual funds. An informal look by State securities administrators at what's actually going on in bank lobbies makes it very clear that the marketplace is sending out a very confusing message.

Some securities regulators have seen false comfort on the part of some bank customers. The truth is that a very substantial portion of bank customers understandably do not seem to grasp the fact that banks have moved beyond their narrow and traditional business of selling only FDIC-insured products. This is particularly true in the case of older Americans, who have been conditioned for 60 years to believe that all products sold within the four walls of their financial institution are governmentally insured.

A review of the customer complaints that we have received thus far sets forth a typical at-risk bank customer. Usually that person is retired, most often over the age of 70 years. Historically, that person has invested only in bank CDs and, as such, has had no real investment experience. This person has no ability to assume risk and is seeking safety of principal. This person does not understand the risks and fees associated with the investment product and is not provided with the proper disclosure of these facts. Finally, this investor or consumer mistakenly believes that he or she is dealing with a bank employee rather than an investment representative when that person is purchasing uninsured investment products.

Among the key concerns that State securities regulators have about this set of circumstances is the covert sharing of financial information between the bank and its brokerage affiliates. This has already been alluded to in prior testimony, and I can assure you

it's a very serious problem. We're also concerned about the inappropriate payment by broker dealers of referral fees to bank employees. This obviously encourages bank employees to misrepresent or at least minimize the differences between traditional bank products and uninsured investment products. We're concerned about inadequate and ineffective disclosure. Consumers may be provided with mountains of information, but it is either unintelligible, arrives too late to be helpful, or the customer relies instead entirely upon the oral representations of the salesperson.

A high percentage of bank brokerage customers are first-time investors who are not financially sophisticated. Clearly, this group is the most vulnerable to being intentionally or inadvertently misled. Unfortunately, the regulatory system has not kept pace. The absence of a clear road map for how banks should engage in this activity is the result of our illogical and inefficient regulatory structure. What NASAA has advocated for some time is a functional regulatory approach to securities activity so that no matter where a customer buys an investment product, whether from a brokerage firm, a bank, or elsewhere, that customer is afforded the same high level of protection.

In closing, I would like to emphasize that NASAA is not opposed to the sale of securities on bank premises. We all recognize that the marketplace has changed, and we all need to respond in an appropriate fashion to protect older Americans. Now that we've discovered these problems, we must act aggressively and cooperatively to cure them.

Thank you, Mr. Chairman.

[The prepared statement of Ms. Crawford follows:]

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STATEMENT OF

DENISE VOIGT CRAWFORD
Texas Securities Commissioner

on behalf of the
NORTH AMERICAN SECURITIES ADMINISTRATORS ASSOCIATION

before the
SPECIAL COMMITTEE ON AGING
U.S. Senate

"Uninsured Bank Products: Risky Business for Seniors?"

September 29, 1994

President: Craig A. Goettsch (Iowa) • President Elect: Philip A. Feigin (Colorado) • Secretary: Marcel de la Gorgendiere, Q.C. (Saskatchewan) • Treasurer: Mark J. Griffin (Utah)
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Executive Director: Fowler C. West

Mr. Chairman and Members of the Committee:

My name is Denise Voigt Crawford. I am Texas Securities Commissioner and chair of the Bank Securities Activities Committee of the North American Securities Administrators Association (NASAA). In the U.S., NASAA is the national voice of the 50 state securities agencies responsible for investor protection and the efficient functioning of the capital markets at the grassroots level. On behalf of NASAA, I appreciate the opportunity to appear before you today to discuss the very serious consumer protection concerns that arise from the sale of uninsured investment products on bank premises.[1]

The focus of today's hearing is a logical extension of the examination this Committee conducted last year into the issue of *"How Secure Is Your Retirement: Investments, Planning, and Fraud."* During that session, the Committee heard from three of my colleagues who testified that there may be no single greater -- and preventable -- cause of dependency on the part of older Americans than the loss of savings due to financial fraud and abuse. At the hearing Barry Guthary, securities commissioner for the Massachusetts Securities Division and then-president of NASAA, identified the sale of uninsured investment products as an emerging problem area for older Americans:

> "[a]s this nation's financial markets continue to evolve, new investment-related problems will emerge. Today, we are faced with two such issues which warrant the attention of the U.S. Congress and state and federal regulators. These two issues are: (1) the entry of banks into the securities arena; and (2) changes in pension and tax laws.[2]

This is not to suggest that NASAA is opposed to the sale of uninsured investment products on bank premises, nor should this statement be construed to imply that NASAA believes there is anything inherently fraudulent or abusive about such activity. In fact, it is the Association's position that banks are now another option for consumers who have money to invest in mutual funds, stocks and annuities and understand the risks in doing so.

THE SALE OF UNINSURED INVESTMENT PRODUCTS ON BANK PREMISES: AN OVERVIEW

State securities regulators are in an unique position to contribute to the examination being undertaken by this Committee into the risks faced by older Americans who purchase uninsured investment products on bank premises. As it became increasingly apparent over the last year or so that banks were being dramatically transformed from their traditional role as lending and deposit-taking institutions into major providers of uninsured investment products, NASAA and its individual members agreed that in order to formulate specific policy recommendations, we would need to know more about the level of consumer understanding of the risks involved in purchasing uninsured products at banks and more about how it is that these financial institutions are conducting their investment-related activities.

As a first step, NASAA joined with the American Association of Retired Persons (AARP) to commission a national opinion survey in which we sought to gauge the level of consumer understanding of the risks involved in purchasing uninsured products through banks. Individual state securities regulators followed up that initiative by conducting an informal look at the marketing, promotional and sales activities at banks where uninsured investment products are now being offered. Finally, a number of states also have submitted information concerning the complaints they now are starting to receive from consumers who believe they have been misled into purchasing uninsured investment products on bank premises.

It is the understanding and anecdotal evidence that has emerged from these initiatives that informs NASAA's testimony here today and provides a vivid "snapshot" of the experiences of the many consumers who have purchased uninsured investment products on bank premises. (It should be emphasized that the data discussed in this testimony is not held out to be a precise reflection of the circumstances of <u>all</u> consumers who make such purchases.)

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[1] For purposes of simplification, the term "bank" is used throughout this testimony to refer to financial institutions generally, including thrifts, savings and loan associations and credit unions.

[2] Statement of Barry C. Guthary, president, North American Securities Administrators Association, "How Secure Is Your Retirement: Investments, Planning, Fraud?," Hearing before the Special Committee on Aging, United States Senate, One Hundred Third Congress, First Session, May 25, 1994, Serial No. 103-8

What we learned from the national survey is that the vast majority of American bank consumers are unaware of the risks and fees involved in the uninsured investment products, such as mutual funds and annuities, that are now increasingly available at U.S. banks and other financial institutions. The survey data indicate that fewer than one in five bank customers knows that mutual funds (18 percent) and annuities (14 percent) are not insured by the Federal Deposit Insurance Corporation (FDIC). The survey also found that a substantial number of Americans are: unsure about the risks involved in such investments sold at banks; not questioned about the appropriateness of these investments for their needs; and unaware of where to turn for regulatory help in the event they have a problem with an uninsured investment purchased at a bank.

The informal look by several states at what actually is going on in bank lobbies makes it very clear why consumers are so confused: the marketplace is sending them a bewildering variety of mixed, garbled and misleading messages. Among the problems uncovered by state securities regulators at the banks were: a blurring of the distinction between traditional bank deposit-taking activities and the sale of uninsured investment products; inadequate or misleading disclosure; and a serious gap in the protections available to consumers who purchase securities on bank premises. Complaints filed with state regulators reveal a similar pattern of bank customers, often retirees, being convinced to transfer their savings from insured certificates of deposit to potentially unsuitable investment products based on misleading or incomplete disclosure about the risks and fees associated with those investments.

Mr. Chairman and Members of the Committee, the primary function of state securities regulation is the protection of small investors from fraud and abuse in the capital markets. As a result, we see the day-to-day implications of what at times may be thought of on the national level only in theoretical terms, or worse yet, dismissed as mere "turf battles" between competing regulators and between affected industry groups. The goal of NASAA in exposing the real and potential problems associated with the sale of uninsured products on bank premises is both to help educate consumers about the risks and fees of these investment opportunities and to help demonstrate why it is that new rules are necessary to close the "consumer protection gap" that now exists in state and federal oversight of this activity.

It is NASAA's view that the time has come for federal legislation to address comprehensively the interrelated issues of securities activities conducted on bank premises and the safeguards needed to protect consumers. Recent events have served to underscore and to bring into focus the concerns expressed by NASAA and its members about the steadily increasing role of banks in the securities markets and the lack of legally-mandated investor safeguards.

The simple fact is that the laws and regulations governing the activities of financial institutions have not kept pace with the dramatic changes in the marketplace. While there have been serious efforts over the years to rationalize the oversight of new bank activities, we nonetheless are left today with a regulatory system that defies common sense, is wholly inadequate, and potentially could result in a serious and devastating loss of consumer confidence.

NASAA supports the adoption of federal legislation in which it is recognized that special circumstances arise when uninsured products are sold at banks that have spent many decades persuading consumers to trust them because of the FDIC protection available for their traditional deposit products. At the same time, state securities regulators -- individually and collectively through NASAA -- are reviewing the adequacy of state securities laws, regulations and enforcement programs with respect to the activities of brokerage firms operating on bank premises. NASAA also is working with representatives of the Securities and Exchange Commission (SEC) and the National Association of Securities Dealers (NASD) to determine how we may best work together to protect consumers who purchase investment products on bank premises.

THE EROSION OF GLASS-STEAGALL BARRIERS

The issue of whether commercial banks should be allowed to tap into new sources of business, including the sale of uninsured products in the lobbies of these financial institutions is no longer an academic question. The fact is that many of the restrictions on the securities activities of banks erected by Congress in the Glass-Steagall Act[3] have been eroded or removed through judicial and administrative decisions[4], thereby allowing banks and their non-bank affiliates to participate in a broad range of uninsured investment-related activities.

The regulatory and court decisions creating loopholes in the Depression-era law banning banks from the securities business have been in place for several years now. However, it only has been recently that low interest rates have prompted the explosive growth in the sale through banks of uninsured products. As these low interest rates have propelled consumers to search beyond traditional bank savings products for better returns, more and more banks have moved to offer their clientele a wider range of financial products. Mutual funds, popular with consumers for a number of reasons, are one of the investment alternatives that many banks are providing in their bid to retain customer assets and generate new sources of revenue.

It is likely that the involvement of banks in the securities markets will continue to grow as bank customers move away from insured deposits and to mutual funds and other uninsured products. Today, approximately one-third of all mutual funds are available through the bank channel.[5] While mutual funds may be the investment product of choice today, it should not be assumed that in the future banks will limit their investment-related activities to such a narrow range of products. Nor should concerns about the potential for consumer harm be minimized based on the fact that banks now involved in the sale of uninsured products generally have confined their activity to mutual funds. As one industry observer so aptly cautioned, "... the 'rising tide' in mutual fund sales has masked the fact that the mutual fund business is not immune from downturns ... ."[6] Finally, I cannot help but wonder what we would be facing today in terms of a banking crisis if banks had gotten into the securities business a decade ago when the "hot" investment product was limited partnerships, which at the time were thought of by investors as good, relatively safe, stable long-term investments and have since gone sour on a colossal scale.

THE SALE OF UNINSURED PRODUCTS ON BANK PREMISES: THE BIGGEST CONSUMER AWARENESS PROBLEM IN AMERICA TODAY?

Just over one year ago, NASAA and AARP first discussed the need to gather additional information about what appeared to be widespread customer confusion concerning the sale of uninsured investment products on bank premises. What we found in a nationwide survey is that the vast majority of American bank consumers are unaware of the risks and fees involved in the uninsured investment products, such as mutual funds and annuities, that are now increasingly available at U.S. banks and other financial institutions. Of particular interest to this Committee will be the fact that we found that it is older Americans to whom uninsured investment products sold at banks are being marketed the most aggressively.

KEY SURVEY FINDINGS

The survey released on January 13, 1994, by the AARP and NASAA was conducted by Princeton Survey Research Associates of Princeton, New Jersey. The results were based on telephone interviews with a representative sample of 1,000 adults living in the United States who reported making financial decisions for their household and also reported using a regular commercial bank.[7] One quarter of the commercial bank customers also use a mutual fund company and one in five (21 percent) use a brokerage company.

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[3] Banking Act of 1933, 48 Stat 162-95 (codified as amended in various sections of 12 U.S.C.)

[4] For example, the Office of the Comptroller of the Currency has used the "incidental powers" clause of the National Bank Act to allow national bankers to engage in certain activities once considered the exclusive territory of investment and insurance firms. The Federal Reserve has used the "closely related" language of the Bank Holding Company Act to expand the permissible product and service lines for bank holding companies.

[5] "Fundamentals," Mutual Fund Research in Brief, Research Department, Investment Company Institute, May 1993.

[6] Matthew Fink, Investment Company Institute, "Rough Weather Ahead for Banks in Mutual Funds," American Banker, February 17, 1994, p. 29

[7] Interviews for the NASAA/AARP survey were conducted during the period October 14-October 31, 1993. The margin of error for the total sample of 1,000 commercial bank customers is plus or minus 3 percentage points at the 95 percent level of confidence. The margin of sampling error for results based on a subset of the total sample is larger.

Major results of the NASAA/AARP survey include the following:

- **The vast majority of bank customers are unaware that mutual funds, stocks and annuities sold at their banks are not insured by the FDIC program.**

  Fewer than one in five commercial bank customers understands that mutual funds (18 percent) and annuities (14 percent) are not FDIC insured.

  Only one quarter (25 percent) of customers at banks where stocks are sold know that these products are uninsured.

  About two in five customers think mutual funds (39 percent) and annuities (40 percent) sold at banks are FDIC insured. Another 43 percent do not know whether such mutual funds are insured, and 46 percent are unsure whether annuities sold at their banks are insured.

  A third (35 percent) of the customers at commercial banks where stocks are sold think these purchases are FDIC insured, and another 40 percent are unsure.

- **People who have actually purchased mutual funds or annuities at their bank are no better informed about the risks associated with such investments than are other bank customers.** In fact, these purchasers are even more likely than other bank customers to think the FDIC program covers their investment in a mutual fund or annuity sold at a bank.

  About half of the people who purchased a mutual fund (52 percent) or annuity (55 percent) at a bank think the purchase was FDIC insured. This compares to 39 percent and 40 percent of all bank customers who think mutual funds and annuities sold at banks are FDIC insured.

  Over a third of those who purchased a mutual fund (36 percent) or an annuity (38 percent) at a bank say no one talked with them about the appropriateness (or "suitability") of their investment.

- **Most people who have purchased mutual funds at their bank are also confused about the costs and fees associated with these investments.**

  Only 36 percent of mutual fund buyers think they pay a front-end sales load, even though many mutual funds sold through banks involve such a charge.

  More than half (54 percent) either believe that there is no redemption fee associated with their mutual fund or are uncertain about the applicability of such a fee in relation to their investment.

  In general, a quarter to a third of all those buying mutual funds at a bank do not know if there is a front-end sales load, redemption fee or other management cost associated with their mutual fund.

- **So, even though banks provide their customers with written disclosure documents about uninsured investments, the material apparently is not effective in communicating important details about the risks and costs of these investments.**

  Most purchasers of mutual funds (85 percent) and annuities (63 percent) sold at banks say their bank provided them with a disclosure document about their investment.

  Most who remember receiving this information also remember taking the time to read it (86 percent of mutual fund buyers and 77 percent of annuity buyers).

- **Bank customers trust their banks and rely upon them to provide good information.**

Almost nine out of ten (88 percent) bank customers feel they have always received accurate information from their banks about the risks of investing. Only four percent believe that they have been misled or misinformed.

Only five percent would contact a government agency for help in resolving a problem with an uninsured investment purchased through a bank. Most (82 percent) would try to resolve the problem by contacting someone at the bank.

- **Bank customers admit they are less secure in their understanding of the risks in investments than they are about other details of banking.**

  Large majorities say it is easy to understand the fees and rates their bank charges (82 percent) and the regulations that apply to different bank accounts (75 percent).

  However, considerably fewer bank customers (57 percent) say it is easy to understand the financial risks involved in making different kinds of investments through their banks.

- **Uninsured investment products sold at banks are marketed more aggressively to older Americans.**

  While only about a third (34 percent) of all bank customers have been contacted by their banks about investing in mutual funds, 47 percent of those aged 65 and above have been marketed to in such a fashion.

The NASAA/AARP findings are consistent with the results of a similar, but narrower public opinion survey released in November 1993 by the U.S. Securities and Exchange Commission that focused on consumer beliefs about FDIC coverage of uninsured investments at banks. What state securities regulators see in these numbers is a distressing pattern of confusion and false comfort on the part of bank customers, a very substantial portion of whom do not seem to grasp the fact that banks have moved beyond their narrow and traditional business of selling only FDIC-insured products. That this is the case is particularly understandable for older Americans, who have been conditioned for 60 years to believe that all products sold within the four walls of a financial institution carry with them federal insurance.

State securities regulators are concerned that increasingly we will see the financially unsophisticated consumers -- those who are the least able to recognize the sometimes subtle distinctions between bank products -- targeted by bank promotional campaigns. A study by financial researcher Phoenix-Hecht showed that about 20 percent of all newcomers to mutual funds make their purchases through banks. A Phoenix-Hecht vice president suggested that novice investors are drawn to banks in part because of their familiarity with the institution.[8] A study released in 1988 by the Market Facts research firm concluded that "... banks will succeed in the sale of nontraditional banking products only by focusing on unsophisticated buyers, often first time investors."[9] The authors of the report advised banks to go after the bread-and-butter customers, the "ones who are confused and a little distrustful of financial products."[10]

What is significant in this context is that banks are continuing to find ways to benefit from what may be the most important thing they still have going for them -- trust. Surveys show that people continue to have more confidence in banks than other financial

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[8] Kalen Holliday, "Banks Keeping Up in Race to Lure New Investors," American Banker, December 22, 1993, p. 16.

[9] Lawrence A. Darby, "To Market New Products, Target the Confused Buyer," American Banker, April 26, 1990, p. 4.

[10] Ibid.

institution.[11] That trust, of course, is rooted in one basic fact: money placed with a bank comes with the federal government's guarantee that it will always be there, even if the bank fails. Although the government insurance does not extend to investment-related products sold on bank premises, that fact is so often downplayed or completely omitted that it is not surprising that consumers are confused. Equally disturbing is the misleading way in which some banks and securities brokerage firms are characterizing the insurance coverage of the Securities Investor Protection Corporation (SIPC) as analogous, if not better(!), than FDIC coverage.[12]

While misleading or inadequate disclosure is a problem in this connection, so too are the identical or similar names of the banking institution and the affiliated brokerage firm and/or its products. The thinking behind common or similar names appears to be simple: a bank's name can be a powerful draw in a local market. A good example of how it is that banks trade on the trust they have built up may be found in the case of the Minnesota bank that was planning to put financial planners in several of its branches. The bank decided to identify the planners as employees of the bank's brokerage affiliate (which had a name similar to that of the bank) because a pilot program revealed that bank customers were more comfortable when they believed that the planners were affiliated with the bank.[13]

CAPITALIZING ON CONFUSION: A LOOK AT SALES PRACTICES

An informal state-level[14] look at the marketing, promotional and sales activities at banks offering uninsured investment products provides startling anecdotal evidence that may help explain why it is that there is widespread consumer confusion and misunderstanding about the risks and fees associated with these products now widely available through banks. What state securities regulators uncovered in their visits to bank lobbies is a marketplace rife with misleading advertising and promotional materials, a systemic breakdown in the distinction between traditional insured activity and the sale of uninsured products, and a serious gap in the consumer protections available to those who purchase investment products on bank premises.

Below are illustrative examples of what state securities regulators found in each of the following major areas of concern: (1) suitability/risk disclosure; (2) misleading references to FDIC and SIPC coverage; and (3) a blurring of the distinctions between bank activities and brokerage activities, including the use of similar or identical names.

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[11] Jerry Knight, "Banks Becoming Financial Supermarkets," Washington Post, August 23, 1993, p. A1 Barry Barbash, Director of the Securities and Exchange Commission's Division of Investment Management, commented on the results of the focus group sessions being conducted by the SEC and the Office of the Comptroller of the Currency to gauge how well consumers understand the differences between mutual funds and insured deposits: "One thing that comes clearly out of the focus groups is that bank depositors really do think of banks as bastions of safety." (Debra Cope, "Regulators Probe Public's Knowledge of Fund Risk," American Banker, January 27, 1994, p. 16.)

[12] The Securities Investor Protection Corporation (SIPC) is a nonprofit membership corporation, funded by its member securities broker-dealers. SIPC does not protect investors against losses from the rise or fall in the market value of specific investments. What it does is provide protection against certain losses if a SIPC member fails financially and is unable to meet obligations to its securities customers. For example, an investor owns $25,000 worth of shares in ABC corporation and the shares are being held by the broker-dealer for safekeeping or for other purposes. In addition, the investor has $10,000 in cash on deposit with the broker-dealer for the purpose of purchasing additional securities. If that broker-dealer fails financially, the investor will receive all the securities registered in his or her name that were being held by the broker-dealer (which in this case is $25,000 worth of ABC corporation stock), and the $10,000 in cash. Customers may receive up to a maximum of $500,000, including up to $100,000 on claims for cash. On the other hand, that same investor would not eligible for SIPC protection if he or she experienced losses in the investment account due to the rise and fall in market value. (See, How SIPC Protects You, a 1992 publication of the Securities Investor Protection Corporation, Washington, D.C.)

[13] Karen Talley, "First Bank System to Place Financial Planners in More Branches," American Banker, October 27, 1993, p. 17.

[14] Twenty state securities agencies contributed information used in developing this testimony. The states include: Arkansas, Colorado, Georgia, Idaho, Iowa, Kansas, Maine, Massachusetts, Minnesota, Missouri, Nebraska, Nevada, New Jersey, North Carolina, North Dakota, South Carolina, Texas, Vermont, Washington state and Wisconsin. The state securities divisions were contacted in mid-February and asked to provide us with information on hand or to go into the banks in their area to gather information on the marketing, promotional and sales activities taking place.

SUITABILITY CONCERNS/RISK DISCLOSURE

- An elderly Washington state resident complained to the Washington state Securities Division that she was misled by a **Tacoma, Washington** bank when she was persuaded to move funds from a maturing certificate of deposit (CD) into a mutual fund. The woman, a Yugoslavian immigrant, had intended to withdraw the funds from the maturing CD and take the money to another bank paying a higher return. When bank personnel learned this, they suggested that the depositor could earn a higher return by putting the money in a "government fund." When the woman asked whether the account would be FDIC insured, she was told that it was a secure investment because it was a government fund. She was told that the return would be significantly higher and that there would be no risk. The bank customer was not advised that this was an uninsured investment account rather than a traditional bank deposit account. The receipt she was given had the bank's name on it, as did the customer account form. There is no mention on any form that the money was being put into an uninsured investment product. It was only when a broker contacted her nearly two years later to advise her to withdraw her funds from the account because she was losing money that the woman learned that her money -- which represented her entire life savings -- had been put in a uninsured investment product and that the principal of her investment had been reduced by nearly $12,000. When the customer went to the bank to complain, she learned that the assistant branch manager for the bank was the very woman who sold her the investment product and claimed that it was safe!

- The Colorado Division of Securities received a complaint from the daughter of an 80-year old widow who had been contacted by her **Denver, Colorado** bank (with which she had done business for 20 years) about investment products at the time her CD was maturing. The widow, an East German emigree, was told she could earn better interest rates if she moved her funds from the CDs into a mutual fund account. The woman later learned that it was not bank personnel with whom she was dealing when she was persuaded to put her funds in mutual funds, but rather a brokerage firm that had a percentage-lease relationship[15] with the bank. This 80-year old woman's life savings were put into a mutual fund that had about $4,000 in fees. Despite her complaints about suitability, the woman was told that because she signed all the proper forms, there was no avenue of redress. After considerable and persistent efforts on the part of the woman, the bank ultimately returned to her the full amount of her initial investment.

- A retired **Crystal, Minnesota** man on a fixed income was invited to his local bank to discuss options when his CD was about to mature. When the man went to the bank for the meeting, he unknowingly was directed by bank employees to speak to an investment sales representative and <u>not</u> a bank employee. During the meeting, it was suggested that the funds be placed in an investment vehicle that would pay a higher rate of interest than the CD, and would be equal to a CD in terms of safety and liquidity. When the man explained that he was not at all interested in any stock deal, he was reassured that what he was getting into would be very similar to a CD. Ultimately the man agreed to put his funds in what turned out to be a limited partnership that, contrary to the assurances, paid lower interest and was not at all liquid. The retiree explained that he had signed the necessary disclosure forms but that he was not given an opportunity to read them, nor was he provided an explanation of what he was signing. The limited partnership prospectus did not arrive at this home until several days <u>after</u> he had made the investment. Although the gentleman later learned that he was dealing with a representative of the brokerage firm affiliated with the bank, at the time he believed he was dealing with representatives of a bank he had grown to trust. The customer claims that there was no physical separation between the banking and brokerage activities and that there were no posters or other signs that would alert someone they were no longer dealing with a bank representative.

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[15] Under such an arrangement, a bank leases space on its premises to a third-party broker-dealer and the bank receives a percentage of the gross sales commissions.

MISLEADING REFERENCES TO FDIC/SIPC COVERAGE

- The promotional materials for the brokerage services of a **Wichita, Kansas** bank suggest that *"All securities in your Brokerage Account are protected by the Securities Investors Protection Corporation for up to $500,000 (limited to $100,000 for claims for cash)."* Customers may mistakenly -- but understandably -- read that statement coming from a bank to mean that the "protection" works in much the same manner as FDIC insurance. Brochures in the bank lobby describing the investment-related services of the brokerage unit failed to include any mention whatsoever that these products are not FDIC-insured.

- The back panel of a brochure promoting the brokerage firm (which uses the word "bank" in its name) affiliated with a **Denver, Colorado** bank describes the uninsured nature of investment products in this manner: "_____ *Securities Corporation is not a bank and* ***some*** *of the investments it makes available are not obligations of, or guaranteed by a bank, nor are they insured by the FDIC."* (Emphasis added.) Another brochure put out by the same brokerage firm includes the following "disclosure," which takes the FDIC/SIPC confusion to the worst extremes uncovered so far:

  You have access to a variety of safekeeping services. *Securities held in your investment account are covered up to $10,000,000 of protection, as detailed in the box below.*

  Protection Insurance
  SIPC
  (Securities Investor Protection Corporation) --
  (Including $100,000 in cash)
  up to $500,000

  Equitable Casualty and
  Surety Company
  $9,500,000

  Total Coverage **$10,000,000**

- When asked about government insurance on a mutual fund, a sales representative operating in the lobby of a **Boston, Massachusetts** bank said that a mutual fund was as safe as a CD. The representative added that the mutual fund is safer in some respects because "an investment in a fund is protected by SIPC up to $500,000, while a CD is only protected up to $100,000." When asked if SIPC was a federal agency like the FDIC, the representative said "no," but that it provided similar protection.

- Brochures promoting the services of a **Lincoln, Nebraska** bank include "Investment Alternatives" under the general heading of "Savings Plans." Although there is a one-line, fine-print sentence indicating that investment products are not FDIC insured, an open panel on the back of the brochure reads "FDIC INSURED" in a general way. If the customer sees the cover, the first panels of text and the back of the brochure, the message certainly would be that the products carry FDIC insurance.

- The brochure for the brokerage affiliate of a **Little Rock, Arkansas** bank advertises its investment-related services and prominently discloses the brokerage's ties to the bank. In fact, the bank name and logo appear in large print, as does the "Member FDIC" notice. Nowhere on the brochure is it stated that FDIC coverage does not extend to investment products.

BLURRING THE DISTINCTION BETWEEN BANKING AND BROKERAGE ACTIVITIES

- An **Arlington, Virginia** bank uses the same logo and a nearly identical name for both its traditional banking and its uninsured investment sales operations. Additionally, the bank logo is imprinted on all of the inserts in a brochure detailing the banking, insurance and investment services of the institution. Brochures for both insured and uninsured products are commingled in the bank lobby and large posters just a few feet from the tellers' windows advertise the availability of the investment products. The lobby posters do not disclose the uninsured nature of these investment vehicles.

- A **Maine** investor did business with a brokerage firm operating out of a bank lobby and using a name identical to that of the bank. He did not understand the difference between dealing with a bank and a securities firm. In his complaint to state securities regulators, the investor made repeated reference to what "his bank had done to him." His dispute actually was with the brokerage firm and involved the fees associated with a municipal income fund he purchased after cashing in his certificates of deposit.

- Customers of a **Topeka, Kansas** bank may understandably be confused by the promotional materials for an affiliated brokerage firm that goes by an identical name, has the same logo, and uses exactly the same art work as the bank.

- Examiners from the Colorado Securities Division illustrated the blurring of the lines between banks and brokerages and the concerns about inadequate disclosure in a report describing the various signs in a **Denver, Colorado** bank lobby. For example, in the area of the bank where investment sales representatives were located there was a small sign signifying "NASD member" and "SIPC." There were no signs indicating that the products being made available by the brokerage firm were not FDIC insured. In addition, a "State of Colorado Charter Bank" sign was displayed on the table immediately adjacent to the investment sales representative's desk.

- A **Boston, Massachusetts** bank and its brokerage affiliate share an identical name and logo that is printed on the front cover of prospectuses for uninsured investment products. Brochures available in the bank lobby contain inadequate disclosure with respect to the risks associated with investment products and no information discussing fees is made available. Finally, there is no physical separation between the investment sales representatives and the bank's customer service personnel. There are no signs that would distinguish the investment and banking-related services.

- A newspaper advertisement for the investment center affiliated with a **Topeka, Kansas** bank reads *"Alternative Investments Are Now Available Where You Bank."* Readers are advised that they may call a bank representative who will set up an appointment with the investment executives. The advertisement directly equates traditional investments (e.g., savings, CDs, etc.) with uninsured products, making them appear to be merely alternatives of the same nature.

- The securities arm of a **Denver, Colorado** bank makes available to customers a brochure that asks:

  Why Talk to ___ about my investment needs?
  A Reliable Financial Planner

  For three generations ___ has enjoyed the reputation of being a premier financial institution. We have been satisfying financial needs with products such as checking and savings accounts, loans and CDs. But, did you know we also provide personal professional investment service through (name of brokerage firm)?

  The return card asks consumers to indicate whether they are customers of the bank and, if so, what branch they most frequently visit.

- A newspaper advertisement running in papers in **Little Rock, Arkansas** displays the names of several big brokerage firms and then asks the reader: *"Which Brokerage Firm Also Offers the Unique Insight of Arkansas' Largest Bank?"* In the text of the ad it is asserted that the brokerage firm in question has not only the expertise and capacity of any national brokerage firm, it is also the "only firm" to offer the "service, convenience and unique insight of the region's premier banking organization." Readers are encouraged to find out "how a regional bank can meet your investment needs on a national scale."

Although it might have been anticipated that such confusing and misleading advertising, marketing and sales pitches would have abated as a result of the release on February 17, 1994, of the "Interagency Statement on Retail Sales of Nondeposit Investment Products," that does not seem to be the case. These interagency guidelines, issued jointly by the Office of the Comptroller of the Currency (OCC), the Federal Reserve Board, the Federal Deposit Insurance Corporation (FDIC) and the Office of Thrift Supervision (OTS) require certain disclosure to customers, suitability review and other procedures that are intended to prevent customer confusion and assure that investment recommendations are appropriate to the particular customer's situation.

On September 16, 1994, Comptroller of the Currency Eugene Ludwig[16] announced the results of the OCC's look at more than 8500 disclosure documents, voluntarily submitted by over 700 national banks to determine whether they complied with the provisions of the interagency guidelines. According to the Comptroller, a working group of national bank examiners reviewed individual, written documents voluntarily submitted by national banks and some third party providers. Documents in the review included brochures, statement stuffers or inserts, advertisements, rollover forms, disclosure forms, and the like.

What the OCC found in its review is that the marketplace disclosures continue to be woefully inadequate, and worse, potentially misleading. Problems uncovered by the review include: (1) inconspicuous disclosure of key items; (2) a lack of disclosure about the uninsured nature of the investment product and the risks associated with it; and (3) incomplete references to SIPC coverage.

Testing programs conducted by independent organizations similarly have revealed that the marketplace continues to suffer from inadequate or misleading disclosure, a blurring of the lines between insured and uninsured activities of banks, and unsuitable recommendations. Customer complaints about the mishandling of their accounts that are now beginning to surface at state securities agencies reveal a similar -- and disturbing -- pattern of abusive practices. Regrettably, it often is older Americans who are convinced to move their funds from insured certificates of deposit to uninsured products that carry with them fees and associated risks.

For example, a review of the customer complaints filed with the Texas State Securities Board reveal that, with very modest variation, the typical "at risk" bank customer:

* Is a retired person, most often over the age of 70 years old;

* Historically has invested only in bank certificates of deposit and, as such, as had no real investment experience;

* Has no ability to assume risk and is seeking safety of principle;

* Does not understand the risks and fees associated with the investment product and is not provided with the proper disclosure of these facts; and

* Mistakenly believes that he or she is dealing with a bank employee, rather than an investment representative, when purchasing uninsured products.

The following examples will help to illustrate the types of customer complaints now being received by state securities regulators:

o A **Towson, Maryland** attorney who represents an elderly, mentally disabled woman recently wrote of an experience in which the 74-year old woman, living on about $550 per month in pension benefits, was invited by an investment representative working out of a bank lobby to meet with him to discuss moving her funds from maturing CDs into other investments. It was only after the fact that the woman discovered that her entire savings had been transferred into mutual funds. In a letter to the Maryland Securities Division, the attorney wrote:

"In my view it should not be permissible for banks to have 'in-house' investment subsidiaries. First, the customer assumes that their investment is insured, seeing the FDIC signs all about the bank. Such is certainly not the case with mutual fund investments. Second, the bank should not be permitted to share with its investment personnel critical financial information of the customer (query: how did Mr. ___ know that Mrs. ___'s CD was coming due?). Third, Mr. ___ was not dealing with a person who had any right to act for her. Fourth, Mr. ___ did not bother to inquire of Mrs. ___ what her financial objectives or resources were prior to selling her the mutual fund. This sale, presumably, netted both the Bank and Mr. ___ tidy commissions. This transaction was certainly not in the best interests of Mr. ___'s client, Mrs. ____, but, rather, appears to have been solely in the best interests of Mr. ___ and his employer."

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[16] See September 16, 1994, letter and related materials from Eugene Ludwig, Comptroller of the Currency, to Donald Ogilvie, Executive Vice President, American Bankers Association.

- An elderly **Aurora, Colorado** couple and their disabled daughter were persuaded to move their savings out of insured certificates of deposit at the urging of an investment representative who operated on the bank premises, and was believed by the customers to be an employee of the institution where they had banked for years. It was suggested to these bank customers that they move their money out of CDs, for which they were earning only 4 percent, and into other investments that would earn them 7-10 percent interest. The couple alleges that the investment representative indicated that he dealt only in *"mutual funds and bonds in a special arrangement with the main bank strictly for the benefit of its most favorite customers and that the funds would be totally liquid and safe -- that we could take it in or out without any penalty or charges of any kind, as it would be completely safe in that bank as is their other program and still guaranteed safe the same way."*

  The husband went on to say that the investment representative assured him that it was "a rare opportunity; that I need have no concern as to any value dropping that since there are only bonds which move slowly and no stocks involved that he with his special skills had complete control of quick and instant transfer into other mutual funds should there be any signs that any would start going down, which is why the bank could guarantee that we would lose no money and that our 7-10 percent interest was very secure." It was only later that the couple and their daughter discovered that there were fees associated with the mutual funds and that there was no guarantee as to the performance of the investments.

- The **Vermont Securities Division** reports that it is investigating the complaints of two elderly women who were persuaded to move their savings out of certificates of deposit after they had expressed concern about the low interest rates. The women transferred their funds to short term government funds that turned sour due to their derivatives holdings. The women allege that they were given a suitability assessment, nor were they told about the risks and fees associated with investment products.

- A 79-year old widow residing in **Lockhart, Texas** was contacted by a bank representative in the summer of 1993 and invited to go to the bank to discuss investment opportunities that would have higher returns than her maturing CDs. The widow had first opened an account at the bank in 1956 and wrote that she "pledged her full faith and trust in ____, its successor ____, and finally ____. This was my bank and whatever they said was OK with me." At the urging of the investment representatives, the woman moved her funds from insured CDs into mutual funds. It was her understanding that she could never lose a penny so long as the United States was sound. The woman said that she signed various papers that she did not understand but did so because she trusted the bank where she had done business for nearly 40 years. It was only when the widow showed her papers to her daughter did she learn that she had put her money in uninsured investment products that carried with them fees and other charges. The woman writes that she feels she has been "misled, defrauded and cheated."

- The **Investor Protection and Securities Bureau of the New York Attorney General's Office** reports that it has received a number of complaints relating to the sale of uninsured investment products on bank premises and that they have a number of ongoing investigations. The general areas of concern are as follows:

  * ***Sharing of information.*** Banks appear to be providing customer account information, such as the amount and maturity date of certificates of deposit, to affiliated broker-dealers. The broker-dealer's salespersons write or phone the customers with maturing CDs, many of whom believe they are being contacted by the bank, not a brokerage firm.

* ***Referral fees***. The payment by the broker-dealers of referral fees to bank employees may provide an incentive for the bank employee to misrepresent or otherwise minimize the differences between traditional bank products and uninsured investment products. The lease-percentage arrangements in which the broker-dealer pays a percentage of its commission revenues in rent for space in the bank lobby also may encourage inappropriate referrals.

* ***Inadequate and ineffective disclosure***. In most cases, customers have said that they never received a prospectus (although they signed a form saying they did) and that they were unaware of the risks and fees associated with the investment product. It is increasingly clear that bank customers may be provided with mountains of information but that it either is unintelligible, arrives too late to be helpful, or the customer relies entirely on the oral representations of the salesperson and does not try to wade through the mandatory disclosures.

* ***Financially unsophisticated investors***. The Bureau's view is that the bank customer most often referred to the affiliated brokerage firm is a first-time investor who is less financially sophisticated than the average investor who seeks out a brokerage firm on his or her own.

CLOSING THE CONSUMER PROTECTION GAP: CURRENT AND NEEDED REMEDIES

Mr. Chairman and Members of the Committee, there can be no doubt that the existing statutory framework is woefully outdated and not up to the demands of a rapidly changing marketplace. As you may know, NASAA, the American Association of Retired Persons (AARP) and the Consumer Federation of America (CFA) have developed the following minimum standards for evaluating Congressional reform legislation in this area:

- ***Mandatory use of disclosure that is proven to work***. It is clear that what is being done now in terms of disclosure is not working. Disclosure about the risks of uninsured bank products should be in the form of a concise and "simple English" document and related lobby posters. No sale of an uninsured product should be permitted to take place before the disclosure document is provided and the consumer signs a statement indicating an understanding that mutual funds, stocks and annuities sold at banks are not FDIC insured. In view of the apparent ineffectiveness of current disclosures, AARP, CFA and NASAA are prepared to assist in the development and testing of model disclosure documents and other materials that can be proven to be effective in eliminating the current consumer confusion about the extent of FDIC and SIPC insurance coverage.

- ***A ban on naming or advertising uninsured bank products in any way that creates confusion with insured bank products or the institution itself.*** Many consumers mistakenly believe that uninsured bank products are FDIC insured in the same manner as traditional bank products. As a result, every precaution must be taken to avoid undue confusion in the consumer's mind about the "dividing line" between uninsured products on the one hand and the safety and soundness of the bank and its traditional insured products on the other. The use of the same or similar names and logos of banks and their affiliates or subsidiaries should be prohibited. Additionally, some mutual funds and other uninsured investment products sold at banks should be renamed in order to bring an end to existing instances of the blurring of the line between uninsured and insured bank products.

- ***No "gap" in the consumer protection available to bank customers buying investment products.*** Consumers who invest in mutual funds and stocks through brokerage firms or investment companies are provided a comprehensive framework of consumer protections, including suitability requirements, fair dealing and disclosure of risks and costs. Though much of the activity in investments sold through banks is conducted by

subsidiaries registered as broker-dealers, there is the potential for banks to deal directly with individuals and firms who would not be subject to broker-dealer regulation. This disturbing possibility has already become reality in some instances. At the same time, a serious effort must be undertaken to review the extent and effectiveness of current state and federal regulatory oversight. All investors in mutual funds, stocks and annuities should be accorded the same level of consumer protection.

- ***A mandatory physical separation of the sale of insured and uninsured products within banks.*** The commingling of insured and uninsured activities in bank lobbies greatly increases the potential for consumer confusion. Because of this, no bank should be able to sell insured and uninsured products from the same desk, window or lobby area. A clear, physical separation should exist (along with appropriate lobby posters) in order to distinguish the areas within banks where the two types of products are sold.

FEDERAL LEGISLATIVE SOLUTIONS

The current mismatched regulatory system defies common sense and should not be allowed to continue. Banking regulations and examinations are generally aimed at ensuring bank safety and soundness and depositor protection. As a result, banking regulators view maintaining the stability and profitability of the institution as their first priority. In contrast, protecting individual investors is the overarching mission of the securities laws and the enforcement efforts taken by securities regulators reflect as much. There simply is no way to attempt to overlay on to the banking laws and regulatory system the mission and purpose of securities laws. It does not work.

Why not let the banking regulators incorporate into their oversight functions the sale of investment products, as some have suggested?

The answer is simple. Banking regulators are not equipped to create a regulatory scheme comparable to that which exists under the federal securities laws. On the securities side, there are laws, rules and regulations that have grown up over a 70-year period to protect investors. In addition, you have not only the federal Securities and Exchange Commission, you also have 51 state securities agencies and multiple self-regulatory organizations, including the NASD and the New York Stock Exchange. All of these entities work together to ensure the integrity of the marketplace. Rather than relying on this experienced and extensive network of securities regulators, some observers have suggested that federal banking regulators -- who have had no prior experience in investor protection, in writing rules or in enforcing compliance in the securities arena -- take on the job of protecting investors who purchase uninsured investment products on bank premises. Further, NASAA questions whether the banking regulatory agencies have the resources to adequately police the investment marketplace.

For these reasons, NASAA has strongly supported the functional regulation approach of H.R. 3447, the "Securities Regulatory Equality Act" now pending before the Energy and Commerce Committee of the House of Representatives (no companion bill has been introduced in the Senate). Importantly, H.R. 3447 is grounded in the fundamental principle that all participants in the securities business should play by the same rules and be subject to the same standards. The continued exclusion of banks from the definitions of "broker" and "dealer" serves no public interest, and to the contrary, means that banks need not comply with the customer protection, net capital, and books and records rules specifically designed to protect investors. What purpose is served in allowing for expansive securities powers for depository institutions and yet not subjecting those activities to legally-enforceable and appropriate oversight? It certainly is not investor interests that are served by such a gaping hole in the regulatory structure. Banks that act as broker-dealers are, of course, subject to federal banking laws. However, those laws are designed to protect the banks and their depositors, not investors.

Consider the following:

- ***Securities laws provide for a private right of action and arbitration of customer/broker disputes***. Securities laws provide for -- and rely upon -- private enforcement actions to supplement government actions. No such system of redress exists in banking laws. The fundamental purpose of federal securities laws is to ensure full disclosure to investors and to punish those who violate the law. Private actions have become increasingly important as an enforcement tool in light of the dramatic growth of fraud and corruption in the nation's business community and financial institutions and the limitations on state and federal prosecutorial and regulatory resources. In short, private actions under the federal securities laws are essential to deter prospective criminals, compensate the victims of fraud, and maintain public confidence in the marketplace. An absence of private actions may well have the effect of eroding confidence in the capital markets, thereby reducing investment and increasing the cost of raising capital for U.S. businesses.

- ***There is a comprehensive scheme under the securities laws for licensing brokers, including training, testing and tracking.*** Although federal banking regulators have claimed that they will require salespersons in banks to meet qualification and training requirements that are determined to be equivalent to the training and qualification requirements applicable to SEC registrants under the securities laws, NASAA questions how this will be accomplished. Will federal banking regulators put in place a similar licensing scheme for bank personnel selling investment products? Will the federal banking regulators be in a position to develop and administer examinations to test the knowledge and competence of applicants seeking to become securities salespersons? Will banking regulators be in a position to monitor the activities of such individuals and take action when appropriate? An extensive and rigorous program for training and testing of applicants is well established in the securities regulatory system. Securities regulators also track the disciplinary history of brokers in an effort to screen out bad actors. In addition, the brokerage firms and self-regulatory organizations now are moving to put in place continuing education programs to ensure that those individuals in the securities business keep current with new products and trading strategies, as well as new laws and regulatory requirements.

- ***Securities salespersons are subject to rules of fair practice***. The rules of the securities industry's self-regulatory organizations and state securities laws and regulations require brokers to comply with rules of fair practice. These rules are designed to ensure that brokers observe high standards of commercial honor and just and equitable principles of fair trade in the conduct of their business. Violation of the rules may result in a fine, suspension or revocation of a securities license. Among the issues covered by the rules of fair practice are: making unsuitable recommendations not in accordance with a client's financial condition, sophistication or risk tolerance; "churning" accounts over and over for commissions; un-authorized trading; misrepresentations as to the possible risks or true nature of the investment product; fraudulently inducing a client to purchase an investment product; and providing advice unfounded in fact. We are not aware of any similar provisions in banking law and regulations.

- ***Securities regulators routinely make available to the public information about the background and disciplinary history of stockbrokers***. The licensing of stockbrokers is accomplished through a sophisticated computer network -- the Central Registration Depository (CRD) -- jointly operated by NASAA and the NASD. Today, the system contains registration and disciplinary files on approximately 5,200 brokerage firms and more than 460,000 individual stockbrokers. The system captures substantial disciplinary history about registrants and draws from several sources for its data. Individual registrants and their employing brokerage firms also are required to disclose fully all disciplinary history; a failure to do so may serve as a separate ground for state licensing actions. The CRD database now serves as a primary source of information for investors to learn about the disciplinary and employment history of stockbrokers. Today, investors may call either their state securities agency or the NASD

to access background data on a particular stockbroker or firm. NASAA and the individual states use every opportunity available to them, including the news media, speaking engagements, public statements, and more, to alert consumers to this service. There are no comparable licensing requirements for bank personnel, nor are we aware of any efforts contemplated by federal banking regulators to design, build or maintain such a computer system for those bank personnel who may now sell securities or render investment advice.

- ***Securities regulators employ a high-profile program for exposing securities law violators, thereby warning the public about a troublesome scheme, firm or individual.*** Federal and state securities regulators, as well as the industry's self-regulatory organizations, deliberately seek to publicize as widely as possible any disciplinary action taken against individual brokers or brokerage firms. The goal is to provide as much information as is possible to the investing public so that they may avoid dealing with unscrupulous or dishonest operators.

Currently, banks also may serve as investment advisers to certain mutual funds without registering under the Investment Advisers Act of 1940. As a result of this loophole, shareholders in mutual funds advised by banks, unlike their counterparts in other mutual funds, do not receive the protections of that Act's provisions, including those related to the recordkeeping and inspections conducted by the SEC and those restricting performance-based fees and other potential conflicts of interest. H.R. 3447 would remove the exclusion for banks from the definition of "investment adviser" under Section 202(a)(3) of the Investment Advisers Act if the bank or bank holding company acts as an investment adviser to a registered investment company.

H.R. 3447 not only addresses the consumer protection gap by significantly narrowing the exclusions from the various securities laws for banks, the legislation also addresses the issue of similar or common names. Section 116 of the bill would prohibit the use of the bank's name, title or logo (including names, titles and logos that are similar to or a variation of) by an affiliated investment company. NASAA's view is that such a requirement would greatly assist in reducing consumer confusion concerning the uninsured status of investment-related products sold on bank premises.

Mr. Chairman and Members of the Committee, it is obvious that such an elaborate and highly specialized oversight function as currently exists for securities brokers and firms simply cannot be duplicated by federal banking agencies, unless there are thousands of employees now sitting in these agencies with nothing to do and millions of dollars of taxpayer money available to be spent on putting in place the duplicative infrastructure that would be necessary to carry out such a program. In addition, such efforts would seem to run contrary to the Administration's stated goal of regulatory consolidation.

NASAA would suggest that a more reasonable and appropriate approach would be for Congress to adopt the functional regulation system envisioned in H.R. 3447. If H.R. 3447 is adopted, the result will be strengthened investor protection, without duplicative and costly overlap in the functions of federal securities and banking regulators. At the same time, NASAA would commend to the Committee for its consideration certain elements contained in H.R. 3306, the "Depository Institution Retail Investment Sales and Disclosure Act," introduced by Representatives Gonzalez and Schumer and currently pending before the House Banking Committee. Among the provisions in that bill supported by NASAA are:

- ***A prohibition on banks sharing confidential customer information with any affiliated securities operations.*** Most bank customers would be extremely disturbed to learn that financial institutions routinely share with securities salespersons what commonly is considered confidential information about the customer's finances, including the maturity dates of these CDs. It is clear that banks are supplying this information to brokerage operations in the hopes of persuading bank customers to purchase uninsured investment products with the funds earned when CDs have been cashed in.

- ***Physical segregation of securities sales activities***. In testimony on March 2, 1994, before the House Energy and Commerce Subcommittee on Oversight and Investigations, federal prosecutors in the Lincoln Savings case claimed that the sale of American Continental Corporation (ACC) bonds in the Lincoln lobbies dropped off sharply after the bank was forced to move the sale of the uninsured investment products out of the bank lobbies. It is clear that one reason consumers are so confused about the uninsured status of investment products sold in bank lobbies is due to the blurring of the distinction between the traditional (and insured) banking activities and the investment-related (and uninsured) activities. There should be a clear segregation of insured and uninsured products. Having said this, NASAA also recognizes that small banks may have great difficulty in achieving the physical and personnel separation that NASAA believes is essential. As such, NASAA is willing to work with Congress and representatives of smaller, community banks to design a modification of this requirement to accommodate such institutions. NASAA believes that such modifications may be accomplished without opening up a broad loophole.

- ***Improved disclosure about the uninsured nature of investment products and the risks and fees associated with them***. It is clear that whatever currently is being provided in terms of disclosure simply is not working. Customers remain confused about the uninsured status of investment products and the risks and fees associated with them. As a result, NASAA supports disclosure that is timely and is proven to be effective. An additional area in which there is a desperate need for clear and accurate disclosure is that concerning SIPC coverage. Whether intentional or not, the discussion in many instances of SIPC coverage in connection with investments sold at banks is clearly misleading. In fact, when SIPC is mentioned, it appears to be designed to give false comfort that it is somehow analogous with FDIC insurance, which is most certainly <u>not</u> the case. In addition, NASAA recommends that the disclosure be required for <u>all</u> transactions, solicited as well as unsolicited.

If H.R. 3447 is adopted, along with key elements currently contained in H.R. 3306, Congress will have succeeded in laying the foundation for what would be an extraordinary piece of pro-consumer, pro-competition financial reform legislation.

<u>STATE EFFORTS</u>

It also is recognized that a serious effort must be undertaken to review the extent and effectiveness of current state securities regulatory oversight. The first order of business for state securities regulators has been to gather information about what is going on in the marketplace and to get a better sense of how it is that banks are entering the securities business. The NASAA committee on which I serve as chair, the Bank Securities Activities Committee, was established nearly one year ago and was charged with reviewing state securities laws and regulations to determine what changes may be necessary in view of the expanding role that banks are playing in the securities marketplace. NASAA also is taking a serious look at the statutory authority of state securities regulators to determine what changes may be necessary in the oversight of registered broker-dealers who operate on bank premises. Finally, a number of individual states also are moving to put in place new rules governing the bank activities of broker-dealers.

CONCLUSION

Mr. Chairman and Members of the Committee, NASAA commends you for focusing national attention on the serious consumer protection concerns that arise as the result of the sale of uninsured investment products on bank premises. The interest expressed by this Committee in the issue is very much appreciated, particularly given that it is, indeed, older Americans who comprise the most "at risk" group. NASAA and its individual members look forward to working with you and your staffs as you move forward in your inquiry into these important issues.

Senator PRYOR. Thank you, Ms. Crawford. We'll have a few questions in a few moments, when our other panelists conclude.

Mr. Pollard.

STATEMENT OF ALFRED M. POLLARD, SENIOR DIRECTOR, THE BANKERS ROUNDTABLE

Mr. POLLARD. Thank you, Mr. Chairman. I am Alfred Pollard, the senior director of legislative affairs at The Bankers Roundtable. I'm pleased to be here today to provide the committee information on this important subject of sales of uninsured products by banks, with a focus on older customers.

Mr. Chairman, commercial banking is among the most, if not the most, heavily regulated industries in the United States. In offering non-deposit product, banks respond to customer demands, but must do so under the eye of multiple Federal and State regulators. There are about 11,000 banks and 2,400 savings institutions, and all told, I'd estimate there's almost a regulator per bank. It's a very high figure.

Bank involvement with mutual funds is limited, since they may not sponsor or distribute funds. They do often do the more difficult work of advising them, however. Bank sales of uninsured funds are normally undertaken in three ways—sales by bank personnel, sales by affiliated companies, and sales by independent third-party vendors. The lion's share of bank sales is undertaken by registered representatives, and this is the reference you made to the OCC saying they want all of them to take this licensing exam.

Properly administered, bank sales of uninsured products add value for customers and provide services that might otherwise be unavailable, particularly where a bank or its branch is the only service provider with a physical presence in a community or neighborhood. Consumers clearly benefit.

Key areas for our industry's focus today include clear disclosure in oral and written communications that products are not insured, that products are not backed or guaranteed by the bank, and that products entail investment risk, including fluctuation in value and possible principal loss. Further, the banking industry believes that products should be appropriate for each person based on their investment goals and financial situation.

We have created a voluntary compliance program. I'm pleased to note the group with which I work, in 1991, put out two documents for its members on voluntary action—first, in the marketing; and, second, in working with outside vendors. Recently, six financial institution trade associations provided the following guide: "Retail Investment Sales: Guidelines for Banks." This is a comprehensive document. It's been cited favorably by the regulators and it runs through the entire gamut of sales of products, from the initial selection of mutual funds all the way through to arbitration of complaints. It makes clear many of the issues you've heard from the earlier witnesses, some of which I thought were fairly positive—that is, keeping the sales in a separate area of the bank, being sure that tellers do no more than simply say "You may wish to talk to someone in this other area," and also the signage, which is very important.

I think from where you're sitting, Mr. Chairman, you can see this model. This is a reduced size version of it that is supposed to be sitting on every desk of every one of these people—"Not insured"—just what I said in my testimony, and, again, that's a model to be used.

I would note the banking regulators have been working on this issue for some time. They both acted to provide information and recommended methods for banks to meet their obligations. A rather extensive set of guidelines, which is attached to my statement, was provided by the OCC. This document and others have underscored new examination guidelines for examiners, and I'd like to emphasize this point. We don't simply have guidelines put out to us, we actually have active examinations.

I would note also that the banking regulators themselves have issued a publication which is available to all banks to put in their lobbies, which we have encouraged. When you open it, this little orange panel has a very important message, which I'm not sure you can see this clearly from where you're sitting: "Deposits are insured by the U.S. Government. Investments such as mutual funds aren't, even if you purchase them at a bank."

Ongoing efforts continue. In a letter to the industry of September 19, 1994, the OCC concluded a review of advertising and marketing materials for uninsured products sold by banks. Over 700 national banks voluntarily participated and submitted over 8,500 disclosure documents. Based on its review, the OCC felt that continued work needs to be done. Importantly, the OCC provided this review prior to the next series of examinations to afford banks the opportunity to improve their efforts. This is a positive approach that will benefit bank customers.

While the OCC review is not scientific, the OCC clearly believes it shows that more needs to be done. Of greatest concern was whether information was conspicuous, and the OCC called for larger typeface and publication away from the back of documents.

As noted earlier, older Americans have long valued their banking relationships, whether they are doing business in big cities or rural areas. Banks that offer uninsured products are still guided by the reality that the vast majority of older Americans come to them for insured deposit products—savings accounts, NOW accounts, and CDs—and banks seek to enhance this through instruments that are fundamental to this important relationship.

As noted in the industry guidelines, banks must ensure that disclosures are made clearly and their customers understand the risks of investment products and their suitability. All elements are critical here—employee training, requirements placed on employees and third-party vendors to adhere to marketing rules, clear and conspicuous disclosures, and an opportunity for customers to make a decision and to demand additional information.

I'll abbreviate my remarks because of the time to note that the OCC, in its guidance document, singled out in the area of suitability concerns for older Americans, and I'll quote:

One example of a critical suitability determination involves sales to elderly bank customers. Many of these customers rely upon investments or savings for retirement income and may consequently demand high yields. They may not, however, have the ability to absorb or recover losses. A nondeposit investment salesperson should also be aware that it is especially important to make a careful suitability recommenda-

tion when dealing with a surviving spouse who is not experienced in investment matters.

Finally, as some members of the Committee expressed today, where older Americans have problems, there are several solutions. First, request further information. Don't buy anything until you're comfortable. Second, go to the branch manager if you can't get the answer you want or are uncomfortable with the service you received. Third, write down your concern at the time. Don't wait until some later time. And, finally, take time to read the materials and demand that they be understandable. The interagency statement put out by the regulators requires banks to have methods for ensuring that customer complaints are reviewed by bank managers.

Let me conclude that banks have strong incentives to inform older Americans about their investments. We have every incentive to maintain customer confidence by demonstrating that banks are the most trusted providers of financial services and that customers should do their business with the bank involved. This is an ongoing effort to which the industry and its trade groups are committed.

[The prepared statement of Mr. Pollard follows:]

STATEMENT

OF

ALFRED M. POLLARD
SENIOR DIRECTOR
THE BANKERS ROUNDTABLE

Mr. Chairman and members of the Committee, I am Alfred Pollard, Senior Director for Legislative Affairs at The Bankers Roundtable. The Roundtable represents the nation's major banking companies. I am pleased to be here today to provide the Committee information on the important subject of sales of uninsured products by banks with a focus on older customers.

Mr. Chairman, full service banks provide a range of insured and uninsured products to meet customer needs. Products have varied over the years to meet changing consumer interests, and banks have long provided securities services to retail customers.

Older Americans have expressed increased interest in recent years in products such as annuities and mutual funds and the ability to shop for these investments in convenient and accessible locations.

Banks are fully committed to ongoing efforts to improve their delivery systems and the range of products available and, most important, to insure that customers are aware of the nature of products and of avenues to air any grievances or concerns they may have. The banking industry, its trade groups and the industry regulators have worked cooperatively to provide guidance on enhancing consumer awareness. This process continues.

I. Background

Under the law, bank offerings of uninsured products-- mutual funds, securities, annuities-- are founded on a bank's agency role and ability to offer products that are related to banking or constitute the business of banking. For example, in the 1980s, banks were permitted to offer discount brokerage and investment advice. Today, banks offer a wide array of important financial products and services as agents to their customers. The public is well served by bank competition in making mutual funds and other products and services available to customers.

Mr. Chairman, commercial banking is among the most, if not the most, heavily regulated industries in the United States. In offering nondeposit products, banks respond to customer demands, but must do so under the eye of multiple federal and state regulators. There are about 11,000 banks and 2,400 savings institutions and, all told, I would estimate that there are nearly as many federal and state bank examiners as banks. A bank or savings institution selling any regulated product faces regulation not only by a state or federal agency, but also federal oversight by one or more of the four primary federal regulators-- the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Office of Thrift Supervision and the Federal Reserve Board.

Bank involvement with mutual funds is limited, since they may not sponsor or distribute funds; banks often do the more difficult work of advising funds on their investments, however. Banks may advise funds and affiliate with funds, but they may not be the actual sponsor. Today, bank sales of uninsured funds are normally undertaken in three ways-- sales by bank personnel, sales by affiliated companies and sales by independent third party vendors. The lion's share of bank sales is undertaken by registered representatives.

Each bank customer base has varying interest in uninsured products, and sales vary by bank and even by branches of a bank. In every instance, be there low sales volume or high, federal regulators and the banking industry have called for additional caution in sales of uninsured products in banks, a move that has been effective. Properly administered, bank sales of uninsured products add value for customers and provide services that might otherwise be unavailable, particularly where a bank or its branch is the only service provider with a physical presence in a community or neighborhood. Consumers clearly benefit.

II. Recent Concerns with Consumer Disclosure and Industry Efforts

Mr. Chairman, surveys have indicated a degree of consumer confusion over the uninsured nature of mutual funds regardless whether sold by a bank or a securities firm. While these surveys may be questioned, they are of great concern to the banking industry. Whether they show a declining rate of confusion or that there is greater confusion over the insured status of an investment-- involving the Securities Investors Protection Corporation (SIPC) or the Federal Deposit Insurance Corporation (FDIC)-- or whether they provide any guidance for the future, the banking industry takes customer matters very seriously. What is clear is that banks are moving ahead to improve consumer disclosures and to create greater consumer awareness.

Key areas for the industry's focus include clear disclosure in oral and written communications that products are not insured, that products are not backed or guaranteed by the bank and that products entail investment risk including fluctuation in value and possible principal loss. Further, the banking industry believes that products should be appropriate for each person based on their investment goals and financial situation.

The banking industry has created a voluntary compliance program for disclosure, an effort it continues to press for improvement. The Bankers Roundtable in 1991, long before current concerns arose, developed with its members guidelines on marketing of uninsured products and on the selection of third party vendors. [Attachment 1]

More recently, six depository institution trade groups-- The Bankers Roundtable, the Savings & Community Bankers of America, the Consumer Bankers Association, the American Bankers Association, the Independent Bankers Association of America and the National Bankers Association-- joined to provide a 38-page guide entitled *Retail Investment Sales: Guidelines for Banks* (February 1994).

This comprehensive document, cited favorably by bank regulators in their own policy statements, contains a thorough review of how banks should manage the need for customer awareness in sales of these products. The document provides clear guidance on almost every topic from location of sales, advertising, sample investment product acknowledgments, suitability, employee qualification, training and compensation, dispute resolution including arbitration and the role of bank management and boards of directors. For example, it is made clear that tellers may not be involved in advising customers on investments and that signage and the "geography" of the branch are important in customer awareness. [Attachment 2]

III. Regulatory Initiatives

Banking regulators also have issued a series of pronouncements intended to inform banks of their obligations and of recommended methods to meet these obligations and to guide bank examiners on what to look for in reviewing the operations of banks in their sales of uninsured products such as mutual funds and annuities. A rather extensive set of guidelines, attached to my statement, was provided by the Office of the Comptroller of the Currency (OCC); similar guidance has come from the other regulators. [Attachment 3]

By way of background, most bank regulators in 1993 provided revised guidance documents to institutions they oversee and in February of 1994 joined together to issue an Interagency Statement on Retail Sales of Nondeposit Investment Products (February 15, 1994). [Contained in Attachment 3]

This document underscored regulatory concerns related to these sales. The agencies subsequently have issued new examination guidelines for their examiners. This has included attention to third party arrangements-- affiliated and nonaffiliated-- and direct marketing by bank personnel. For third party vendors, regulatory exams focus on agreements with the third party, bank criteria for selecting the third party and a bank's methods for determining the vendor's compliance with bank policies and the interagency statement. Examiners must review disclosures and advertising, employee training and verify how suitability determinations are made, compensation programs and physical settings. Higher standards exist for sales by affiliated third party vendors. Finally, for bank direct sales, examiners are called upon to review carefully disclosure and advertising, compensation programs, physical operation and to see that training programs are comparable to industry standards for insurance agency, brokers or registered securities dealers and that where appropriate employees are licensed or registered under applicable law. Regulators are looking for banks to conform their suitability standards with the Rules of Fair Practice of the NASD; this includes information on income, tax status, net worth (net of residential real estate), current investments, risk tolerance and investment objectives.

Ongoing efforts continue. In a letter to the industry of September 19, 1994, the OCC concluded a review of advertising and marketing materials for uninsured products sold by national banks. Over 700 national banks voluntarily participated and submitted over 8,500 disclosure documents. Based on its review, the OCC felt that continued work needs to be done. The OCC provided this review prior to the next series of examinations to afford banks the opportunity to improve their efforts. This is a positive approach that will benefit bank customers. While the OCC review was not "scientific," the OCC clearly believes it shows that more needs to be done. Of greatest concern was whether information was conspicuous, and the OCC called for larger typeface and publication away from "the back" of documents.

On annuities, the OCC called for greater clarification of the terms guaranteed or insured to indicate this related to the product involved, not to the FDIC or the bank, and to avoid terms that might also refer to banking products. The OCC even noted that while insurance companies may use these terms, banks needed to add greater clarity for their customers. Here one can see a clear focus on banks maintaining a higher standard than that required of other financial service providers. The OCC called on the industry for assistance. OCC guidance was helpful and clear and was sent to the presidents of all national banks.

IV. Older Americans

As noted earlier, older Americans have long valued their banking relationships whether they are doing business in big cities or rural areas. There is a clear convergence of the interest of older citizens and banks-- both seek stability, safety and soundness, security, confidence and someone with whom to work over time on financial affairs. This is true in the area of uninsured product sales and is true regardless of regulatory involvement. Banks are guided by the realization that older Americans have mature investment portfolios, are seeking safety, are seeking good returns over time and protection of principal. Banks look for long term relationships. Older Americans are important customers and seek a broad array of choices in convenient locations.

Banks that offer uninsured products are still guided by the reality that the vast majority of older Americans come to them for insured deposit products-- savings

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accounts, NOW accounts, CDs-- and banks seek to enhance through such instruments that fundamental and important relationship. As noted in the industry guidelines, banks must insure that disclosures are made clearly and that their customers understand the risks of investment products and their suitability. Some banks maintain computer software that permits information gathered, along the lines of the NASD Rules of Fair Practice, to be employed in adding to a decision on suitability. All the elements are critical here-- employee training, requirements placed on employees and third party vendors to adhere to marketing rules, clear and conspicuous disclosures and an opportunity for customers to make a decision and to demand additional information. Bank customers need to know what they are acquiring when they invest in financial instruments-- a need the industry has committed to meeting.

The OCC in its guidance documents has called on banks to exercise, where appropriate, additional care in working with older customers. Particularly in the area of suitability, the OCC noted

> One example of a critical suitability determination involves sales to elderly bank customers. Many of these customers rely upon investments or savings for retirement income and may consequently demand high yields. They may not, however, have the ability to absorb or recover losses. A nondeposit investment salesperson should also be aware that it is especially important to make a careful suitability recommendation when dealing with a surviving spouse who is not experienced in investment matters. *Comptroller's Handbook for National Bank Examiners*, section 413.1.

Finally, where older Americans have problems there are several solutions-- first, request further information-- don't buy anything until you are comfortable; second, go to the branch manager if you cannot get the answer you want and demand additional assistance; third, write down your concern at the time-- don't wait until some later time; and, finally, take the time to read materials and demand that they be understandable. The Interagency Statement requires banks to have methods for insuring that customer complaints are reviewed by bank management.

Banks have strong incentives to inform older Americans about their investments; banks have every incentive to maintain customer confidence by demonstrating that banks are the most trusted providers of financial services and that customers should do their business with the bank involved. This is an ongoing effort to which the industry is committed.

Attachment 1

The Bankers Roundtable

Policy Statement on Marketing of Uninsured Products

Voluntary Guidelines on Marketing of Uninsured Products

1. Insured/Non-Insured Feature. Show prominently on all marketing and offering materials whether the product is not insured by the FDIC.

2. Customer Understanding. Establish procedures to ensure that customers have been advised and understand when the product is not insured by the FDIC or another government agency; this may include some form of written acknowledgement.

3. Designated Sales Areas. The marketing of traditional banking savings products in the same sales area as uninsured products makes it all the more essential that merchandising materials and financial instruments clearly and prominently reflect the uninsured nature of the investment products being sold. The clear and prominent disclosure of the non-insured status of banking and investment products diminishes the need for segregated areas for marketing insured and non-insured products.

4. Terms of the Offer. Adhere to the industry's code of ethics (i.e., FACE) in all aspects in advertising and promoting non-insured products.

5. Compensation/Incentives. Insure compensation and incentive programs do not motivate sales behavior that is inconsistent with preserving the trust and regard of the American public. Cultivate a customer-oriented sales ethic: "If it's good for the customer, it's good for the bank."

6. Training and Monitoring. Insure sales teams, whether bank employees or bank-sponsored third parties, understand clearly customer-oriented sales ethics and the differences in the legal requirements and customer benefits of insured and uninsured products. Monitor compliance with these guidelines consistently, and enforce high standards of accountability in all sales efforts.

The Bankers Roundtable believes that prompt action in adopting these guidelines and following those promulgated by the regulatory agencies will result in stronger customer relationships, more effective sales activities and more profitable consumer banks.

Adopted by The Bankers Roundtable Board of Directors, April 1991; Revised September 1991.

The Bankers Roundtable

Policy Statement on Uninsured Product Vendors

Voluntary Guidelines on Selection of and Sales by Third Party Vendors of Uninsured Products

1. Financial Strength Standards. The financial health of product providers is the critical safety net for insuring that products meet consumer expectations regarding performance and security. Evaluate financial strength of product providers with standards no less strict than those required by bank lending policies.

2. Acceptable Investment Practices. The earnings of investment product providers is highly dependent on their investment practices and, in turn, their capacity to meet the terms of customer agreements. As part of due diligence procedures, assess comprehensively third party investment policies and practices.

3. Adequacy of Regulatory Oversight. Third parties are subject to regulatory oversight of both national and state agencies. Review carefully the quality and rigor of regulatory oversight of all product providers in jurisdictions in which they are licensed to operate.

4. Ongoing Commitment to the Product. Due diligence practices should go beyond product marketing skills or capabilities to consider the provider's capacity and willingness to maintain its commitment to the business and to the product over time.

5. Clear Product Features/Pricing. Insure that the products to be sold are competitive with similar products, that terms and conditions are clear and easy to understand, and that there are no hidden charges or penalties.

6. Consumer Disclosures and Protection. Adhere to the industry's code of ethics (i.e., FACE) and with The Bankers Roundtable's marketing guidelines in all aspects of advertising for, and promotion of, non-insured investment products; adhere to the voluntary guidelines developed by the banking trade associations and endorsed by the bank regulators governing disclosures and business practices. Incorporate disclosures into the sales process and install systems to ensure that the right products are sold to the right customers. Design and implement a detailed consumer sales compliance policy.

7. Consistent Implementation Oversight. Insure that implementation activities are consistent with and support the bank's overall goals and objectives, its ethical standards, and its corporate and investment product strategies. Make vendors aware of the obligations of banking institutions to their customers.

Adopted by The Bankers Roundtable Board of Directors, September 1991.

Senator PRYOR. Thank you, Mr. Pollard.
Mr. Galloway.

STATEMENT OF SCOTT GALLOWAY, CO-FOUNDER, PROPHET MARKET RESEARCH AND CONSULTING

Mr. GALLOWAY. Thank you, Mr. Chairman. It's an honor to be here. This summer Prophet Market Research conducted the first annual national bank security service audit, which consisted of 400 mystery shops. Now, what is a mystery shop? A mystery shop——

Senator PRYOR. You're saying mystery shop?

Mr. GALLOWAY. Mystery shops, and I'll try and define what that means. A mystery shop consists of an independent contractor—we have over 100 independent contractors who conduct these mystery shops—who will contact a bank asking about rates. At that point, they're usually referred to an investment representative. They will then meet with the investment representative just as any typical investor would do. The meeting will take anywhere from half an hour to an hour and a half. Immediately following the mystery shop, the independent contractor will fill out a static questionnaire that records respective levels of disclosure, customer service and sales effectiveness.

The national bank security service audit conducted this summer, as far as we know, is the largest of its kind. The study included 400 mystery shops, 8 mystery shops for each of the 50 largest banks in the Nation who have a bank brokerage unit.

We are not measuring in many respects compliance per se. We don't really measure how many prospectuses or what is in the prospectus or what is signed. If the individual leaves the branch after the meeting and does not understand that these products are not backed by the FDIC, then the bank and the investment representatives, in our eyes, have failed, regardless of what they take home with them or what they have signed. So in a sense, we're testing communication as much as compliance.

With no further ado, let's get to some of the data. It's sort of hard to encapsulate a data set with over three-quarters of a million data points with five graphs, but I'll do my best.

Some of the more encouraging findings. We did a similar study for Money Magazine in March—100 mystery shops at 33 bank brokerage institutions around the United States. In almost every major category that was highlighted in the Money Magazine article, our study this summer registered significant improvement.

Now, for those of you with statistical backgrounds, you might reply, "Well, the sample size for the study in March was much smaller at 100, it's not valid." The changes here are so dramatic that there is definitely a tangible trend. Something positive has happened in the industry.

Going on to the next board, one of the more disturbing findings. The mystery shopper will fill out each question on a scale of 0 to 5. In this case, the question we're talking about is whether or not the investment representative mentioned lack of FDIC insurance. If the investment representative was given a 5 by the mystery shopper that meant not only did they bring up lack of FDIC insurance, but paused to ensure that the prospect understood what they were talking about. In other words, the representative did a truly

outstanding job of communicating that this product that they were talking about was not covered by FDIC insurance. A score of 1 meant that it was never brought up.

As you can see here, approximately 20 percent, according to our scale, did not do what we feel is an adequate job of disclosing lack of FDIC insurance. Again, 20 percent of the 400 shops that took place. This is obviously somewhat of an upsetting finding given that it's hard to believe that any investment representative does not understand that there is supposed to be some sort of verbal disclosure.

Given the context of this hearing, I thought it would be interesting to do sorts by age. We found that age in fact was a driver of service. We found that older customers or seniors or more mature—I'm not sure what the politically correct term is—older prospects received better treatment, fuller disclosure, better customer service.

We feel this is primarily driven by three factors. First, because of the increased scrutiny bank brokerages are making an effort to give greater compliance to their more mature customers. Second, older customers have more money—they're hotter leads, so to speak. As a result, investment representatives are more eager to spend more time with them and do a better job. Establishing rapport is inextricably linked to providing better compliance. If you get to know somebody's financial situation, you can't help but disclose most of the major compliance issues.

A third, less encouraging finding is that younger people are somewhat of an anomaly in many of the bank brokerages around the Nation and subsequently do not receive adequate suitability. For example, when I've done mystery shops myself, I'll find a lot of times I'll sit down and be told, "Young man, you should be in equities." They assume that you must have a long time horizon and that you should be in equities. There's little suitability done.

When I say suitability, I mean the ability of the investment representative to learn about the prospect's investment objectives and risk tolerance and recommend an appropriate investment vehicle. Two key components of establishing suitability would obviously be finding out the prospect's income level and tax bracket. In our study of 400 mystery shops, we found that approximately 46 percent of our sample were not asked income level, and 40 percent were not asked tax bracket—two relatively fundamental questions when determining suitability.

Finally, we found that gender was in fact a driver. I think this is a problem that's endemic to a number of industries, and bank brokerages are no exception. Women had a tougher time being recognized as a prospect. They weren't as easily referred, and once they got hold of the broker, the IRs in general weren't as anxious to get back to them. Also, they didn't receive the same level of disclosure. I might also add that female investment representatives didn't treat women any better than male investment representatives.

I don't think there's any overt misogyny occurring in the industry. I think what you have here are latent assumptions about a female's ability or authority to make investment decisions for her household. As a result, certain very subtle inequities occur. Beyond some of the ethical issues here, obviously it's not smart behavior

on the part of the banking industry when you look at the amount of wealth in this country that is controlled by females.

This is evidence of the power of mystery shopping. When we tell investment representatives that they're in fact treating a segment of the population, regardless if it's based on gender or age, differently, they're usually horrified. The key is to let them know that in fact this is taking place.

To sum up, if it is possible to sum this up, there are definitely areas of concern for each group that we segmented. I would think most parties would like to take a zero-tolerance approach to many of these issues. However, we did find some trends that were very positive when looking at historical performance.

[The prepared statement of Mr. Galloway follows:]

Testimony by

SCOTT GALLOWAY

PROPHET MARKET RESEARCH & CONSULTING

EXECUTIVE SUMMARY

"Some encouraging improvement, but a long way to go" is the phrase that would best summarize the findings of the 1994 National Bank Securities Service Audit study. Compared to our last industry study of 100 mystery shops completed in March 1994 for *Money Magazine*, there were several areas that registered notable improvements, including:

	Money March 1994	NBSSA August 1994
Failed to mention lack of FDIC insurance	31 %	20 %
Did not differentiate from traditional bank products	28 %	19 %
Did not complete a customer profile	27 %	12 %
Did not describe sales loads	41 %	17 %
Did not correctly describe operating expenses	67 %	33 %

An increased focus on compliance, coupled with the nationwide media attention from publications such as *Money Magazine*, may have inspired many bank brokerages to implement internal practice reviews and external shopping programs. While these efforts appear to be bearing fruit, it seems that some bank brokerages have gone from "really bad" to "bad." One in five of our mystery shoppers was *not* told that the products being pitched lacked FDIC insurance. In addition, an alarming percentage of the shoppers was *not* asked income level or tax bracket.

The study also points to evidence of poor sales effectiveness, which may be resulting in lost revenues for the brokerage or parent bank. The *majority* of investment representatives (IRs) shopped either did not attempt to cross-sell other bank products or failed to investigate the prospect's other assets. Given that many brokerages utilize a commission-based compensation structure, a surprisingly high ratio of IRs exhibited poor closing skills. A significant number of IRs adequately disclosed and explained product benefits but failed to ask for the prospect's business or schedule a follow-up appointment--two techniques that are often considered "basic" to most sales efforts.

There was significant variability among the institutions, but many consistently scored above or below the mean. Of the 50 institutions shopped, more than 80% (42 institutions) had at least one IR in their sample who may put the parent bank and prospect at risk due to compliance violations. Thus, while many institutions can boast a strong composite score on the survey, in PROPHET'S opinion, very few can be granted a clean bill of health. The data also reveals a strong correlation between compliance and sales skill scores. Contrary to conventional thinking, this implies that compliance and production are in fact complementary.

Several trends were consistent throughout the data set:

- The older the prospect, the better the compliance scores. This may be the result of a heightened awareness of the "little old lady" syndrome, or it may be that young prospects receive poorer service because they are somewhat of an anomaly in a bank brokerage environment.

- Another consistent finding is that female prospects receive different treatment than their male peers. Women had more difficulty scheduling appointments and were twice as likely *not* to be told about the lack of FDIC insurance.

- Finally, IRs in the Northeast region appear to follow compliance guidelines more rigorously and demonstrate a deeper knowledge of products than IRs from other regions.

If there are questions regarding the methodology, data, or interpretations contained in this report, please feel free to call either Scott Galloway at 415-695-9610 or Lee Lodes at 415-751-5064.

Prophet Background

Prophet is a national market research firm based in San Francisco with offices in San Diego and Chicago. Prophet has been featured in publications such as Forbes and Inc. magazines as an example of a new generation of companies that leverage technology to provide clients with superior service. Prophet's clients include some of the nation's most respected corporations ranging from Apple Computer and The Gap to Yamaha Motors and Sandoz Pharmaceuticals. In addition, Prophet has completed assignments for banking institutions in every major market.

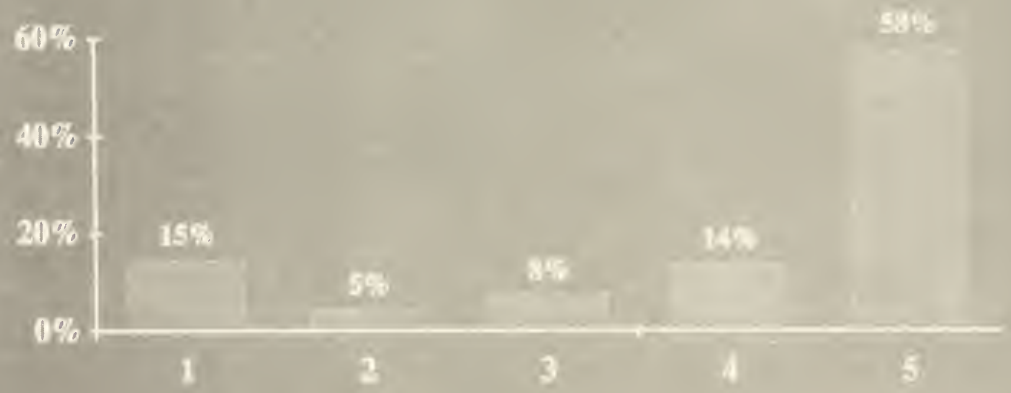
Scott Galloway , Principal: San Francisco — Scott is responsible for research design and translating data into definitive marketing and product recommendations. Since co-founding Prophet, Scott has originated and developed new products and marketing programs for The Gap, Symantec, Williams-Sonoma, Yamaha Motors, Apple Computer and several bank brokerages. As a result of his work on bank mystery shopping projects, Scott has appeared as a featured speaker at symposiums held by the Consumer Bankers Association and the Bank Securities Association.

Scott's work experience prior to founding Prophet includes positions in the fixed income and market research departments of Morgan Stanley and Peter Norton Computing, respectively. He received a BA in economics from UCLA and an MBA with an emphasis in marketing from UC Berkeley. Scott was awarded his series 7 license in 1987.

Improvement since March '94

	March Money	August NBSSA
• Failed to mention lack of FDIC insurance	31%	20%
• Did not differentiate securities from bank products	28%	19%
• Did not complete a customer profile	27%	12%
• Did not describe sales loads	41%	17%
• Did not correctly describe operating expenses	67%	33%

IR Mentions Lack of FDIC Insurance



Implication: **20% scoring poorly**

PROPHET

Hypothesis: Seniors receive better treatment

	<40	41-56	57+
ID customer needs	3.7	4.0	4.2
Fill out NAW	3.3	3.2	3.9
Learn income level	3.1	2.9	3.5
FDIC	3.7	4.0	4.2
Distinguish from bank	3.5	3.6	4.1

PROPHET

Suitability
IR Finds Out Prospect's Income?
Scored 5
54%
Scored 1
46%
Scored 1
40%
Scored 5
60%
IR Finds Out Prospect's Tax Bracket?
PROPHET

Hypothesis: Gender Impacts Treatment

	Male	Female
Ease of reaching IR	4.5	4.0
Staff referral	4.0	4.1
Convenience of meeting	4.4	4.4
FDIC	4.2	3.6
Not backed by bank	3.9	3.5
Principal Destination	4.3	4.0
Learn fax broccoli	3.4	3.2
Disclose charges	3.9	3.6

PROPHET

Senator PRYOR. Mr. Galloway, you think things are getting better or worse?

Mr. GALLOWAY. Oh, no doubt, they're getting better.

Senator PRYOR. What is causing them to get better?

Mr. GALLOWAY. It's two things: Scrutiny that's been placed on the industry as a whole; and bank brokerages realize that compliance and service are inextricably linked, and they want repeat business.

Senator PRYOR. But you still maintain that "One in five"—I'm quoting from your study—"of our mystery shoppers was not told that the products being pitched lacked FDIC insurance." That figure still holds, 1 in 5?

Mr. GALLOWAY. That figure still holds, and I might add in March it was 1 in 3.

Senator PRYOR. One in three. So we've made some improvement since that time. What about the new exam that is going to be required of people who deal in these securities?

Mr. GALLOWAY. My understanding is that they're saying that anyone selling securities is going to have to have a series 7. The majority of investment representatives we deal with already have a series 7, so I don't see it, quite frankly, as having a huge impact.

Senator PRYOR. What can the Congress do, what should we do to make sure that everyone receives full disclosure with regard to a potential investment?

Mr. GALLOWAY. I'm flattered you would ask me that. I'm not sure I'm qualified to answer.

Senator PRYOR. I'm not sure we're qualified to answer it, either, but I am searching.

Mr. GALLOWAY. I've never met with a bank management that isn't sincere about doing anything they can in terms of compliance, and that even includes sacrificing profits. However, if you look at the data at the field course level, it's not taking place.

Senator PRYOR. Let me switch to Mr. Pollard just a moment, and then I'm going to move to Ms. Crawford.

Mr. Pollard, we have here a brochure where down in the middle of the document in barely discernable boilerplate language, is something about no FDIC coverage or insurance or protection. Now, is that full disclosure?

Mr. POLLARD. What we would like to see, Mr. Chairman, first of all, is disclosure much more to the front and not on the back. We would like to see some larger typeface, and I think what you're seeing and what the Comptroller saw when he got these 8,500 documents was that some people were doing it 1 or 2 documents, but not necessarily on document number three or four that they were handing out.

So I think what we're really seeing is not that folks weren't doing it, but when you submit 10 pieces you're using, they may have put it on one or two that they thought were critical and doing a good job but perhaps weren't putting it on document No. 3 or 4 or 5. We have made clear and the industry has made clear and we are pressing our members, as is the Comptroller, as is the FDIC and the Office of Thrift Supervision, everyone, to get these things bigger, up front on your materials. So I frankly would like to see it larger.

Senator PRYOR. In recent years, we passed something called truth in lending. If I go to the bank or the S&L, if there are any S&L's left, or whatever and I want to buy a home or I want to buy an automobile, one of the little pieces of paper that I sign says that I am fully aware of the rate of interest, of the payments, that I've been given full disclosure. Now, is such a disclosure form filled out by a consumer of these investments?

Mr. POLLARD. Yes, absolutely, and that also is something we have called for and the regulators have been handed.

Senator PRYOR. Now, is this a Federal law that——

Mr. POLLARD. Under regulation.

Senator PRYOR. Under regulation.

Mr. POLLARD. Let me add here—and I think you raised an important point, and I think some of the other witnesses raised it—and that is, we don't want to overload people, either. We need full, clear disclosure. We don't need a 60-page checklist of items. That's going to lose people. And what I think you're seeing is the industry developing those clear, central concepts. You're paying a fee, all the disclosures about not being insured and all of that, all of the various information items are finally, I think, pulling together what the consumer can digest, can understand in that form. We don't want people signing stuff that they're signing something they didn't understand. We want it to be clear that what they heard and what they're signing match. That's what is going on.

Senator PRYOR. What about a one-pager?

Mr. POLLARD. Yes. That's what I'm talking about.

Senator PRYOR. Just say "My name is Joe Jones, I am in the process of purchasing securities from so-and-so bank, and it has been fully disclosed to me that should I purchase these securities, that my funds are not insured by the FDIC or any branch of the U.S. Government." Now, do we have such a form like that?

Mr. POLLARD. Those forms are crafted by each bank; however, those forms exist throughout the industry.

Senator PRYOR. Is that a regulation that they must exist?

Mr. POLLARD. Yes. The examiners require this. They're looking for it when they go into a bank. That's the positive point, Senator. We don't just put out a guideline for folks. The actual examiners go into the bank—that's why I was highlighting how many examiners there are—go in, collect all this material, demand that senior management have reviewed it, and check for compliance.

Senator PRYOR. All right. Mr. Pollard, we have together some letters that we have gathered from FDIC and Securities Exchange Commission. We could have gotten a lot more. We could have gotten several hundred, I think. These letters are from people who feel like full disclosure was not made to them with regard to an investment. Now, did these people sign at the bank a form that full disclosure was made and that they understand that their investment was not guaranteed by the FDIC?

Mr. POLLARD. I would hope that they signed at the time of making that investment right then and at that moment that they understood and in their communications that they understood. I think what I also indicated is that that's why it's important for consumers to know when they're in that branch that if they're not clear, that's the time.

Senator PRYOR. We had a tremendous panel that testified earlier. What about the fact or allegation that individual private bank accounts and balances are with the bank's brokerage subsidiaries in order to generate sales to bank customers? What's the ethics there? We've got to do something in that area.

Mr. POLLARD. I think it's very important, and I do believe it was perhaps a bit misstated. Information on people's accounts are held very, very securely.

Senator PRYOR. It doesn't sound like it from our original witnesses.

Mr. POLLARD. We do market products, and I'm sure you have received in your bank statement at times credit card information, and about other products. That is what is taking place. Bankers make available to customers information on other products that we are permitted to sell, and that's taking place.

Senator PRYOR. Well, what about this sharing of information? Senator Burns made mention of this—he bore down on what a violation he felt this was. Is this occurring?

Mr. POLLARD. I think the Senator used the word "public," and I think that's what his concern was. There's no public sharing of information.

Senator PRYOR. Well, if 200 bank or brokerage employees can find out what I have in my bank account in that particular bank, that's almost public.

Mr. POLLARD. Right. What I think you actually have is a bringing of the suitability rules to bear on saying, should we market this product and to whom, and that's what you're seeing within the banking environment, not between the bank and anyone external.

Senator PRYOR. Mr. Pollard, with all due respect, and once again this is not bank bashing, I do feel that some of your responses seem to be a little bureaucratic, and I think what we have here is a problem of disclosure of individual bank account balances. I think we're perhaps seeing a targeting of seniors with regard to some of these investments. As I've gone through this hearing and listened to some of our experts and also some of those who were the investors, I'm more and more convinced that we've got a real problem here I did not realize that we had.

Ms. Crawford, would you like to comment?

Ms. CRAWFORD. Yes, Mr. Chairman. Thank you. During this session of Congress, Congressman Gonzalez introduced bill H.R. 3306, which would have prohibited the sharing of this information, and it's my belief that if most Americans were aware of the fact that their supposedly confidential information is shared so readily, they would be outraged. I think that the fact that you haven't been inundated with letters from your constituents is a result of their ignorance on this point.

Senator PRYOR. I must say, I was ignorant of it. I had no idea this information got that degree of attention in a financial institution.

Mr. Pollard.

Mr. POLLARD. Senator, I think the point, though, is that in making products available to customers that they want and would like to see and know are available that we're permitted to sell to them, it's simply an opportunity to market those. It is not—the key point

here is that suitability is really what we're looking at. In other words, we can tell them there's a product available, but the suitability standards doesn't mean they can come in and we're just going to say, "Great, buy it." It is, again, matched to their personal investment need.

Senator PRYOR. OK, a question of ethics. A customer goes up to a bank teller, someone they've known for a long time, and they're standing there at the window making their deposit or writing a check, and they say, "Well, I just sold my car the other day. I got tired of it, and I'm going to use the subway, so I sold my car." The bank teller calls up the broker in the back of the bank and says, "Ms. Susie Jones is out here in the lobby, and if you'll talk to her, she's just sold her car. Maybe she's got some cash. Maybe you can sell her on some securities." The broker makes the contact, makes the sale, and a commission or gift is given to the teller. Is that ethical?

Mr. POLLARD. I think what we are working to ensure is that our compensation schemes, and as some of the witnesses said, we don't want to overincent anything. For example, there has been a recommendation to the Comptroller and us that if you want to incent, you should incent for the CD as well. In other words, the person should say, "What is your investment motive?" Hopefully, a teller is not involved in this. A teller should simply be taking the customer's funds, as you say, and preparing a deposit or handing them a check. If the customer says, "I don't know what to do with this money," then they might suggest that they * * *.

Senator PRYOR. I just as with the relationship between a lawyer/client or doctor/patient, I think that the teller's relationship with the customer is a confidential relationship and it appears to me is being breached. I was not aware that it's being breached, but according to the documents we've seen it would seem that it is. One of our witnesses gave us this document that says: "For internal use only—Not for distribution to the public." It would appear that you ought to have a sign in each bank saying that if you ask for information, if you ask whether taxes are too high, if you ask whether you've changed your lifestyle or moved or whatever, that you may be contacted by a broker representing this bank. Almost that would be some disclosure that might have to follow if this practice continues.

I think we need to really look at the ethical areas here of the relationship between the bank employee and the customer.

Mr. POLLARD. Well, I think it's critical that the bank employees understand what our fundamental service is, and that is to provide the customer the services they want. The referral items up here, as you noted, are items that when people do have changed circumstances, it may be appropriate for them to be aware of other products. But that's what we're talking about, making the information available to them. And that's where I think it's important what you said about compensation or referral schemes. They should not overincent toward that, and that's why we're suggesting that even CD's, if you're going to incent for referring it to the investment side, you may want to incent the employee for saying, "Well, you may also want to keep a CD here."

As you may know also, at the beginning of the hearing there was a great number of people saying, "Well, rates went up." We did have a lot of customers, as you can imagine, who came in not for advice, but others who came in just to make a purchase. They just came right in and said, "I want to buy a higher yielding investment. I want my check out of here, and I want to make that investment. Where can I do it?"

Senator PRYOR. Now, what the interest of the customer is not necessarily always the interest of the bank, or the best interest, I should say, of each. I think that we've got to stress in our financial institutions that the best interest of the customer has always got to receive the dominant position in this whole dialogue.

Mr. CRAWFORD. Mr. Chairman, if I might interject, there have been a number of references to the OCC guidelines, and while the guidelines are good as far as they go, I have to question the enforcement mechanism. As you know, in the regulation of banks, the primary philosophy is to assure the safety and soundness of the institution. What that means is that if there is a problem with a violation of the guidelines, whatever steps the OCC or the other body that has jurisdiction over the bank does take may well be nonpublic. In other words, the customers of the financial institution will not know that there was a problem, and they will not know what action, if any, was taken against the institution.

That varies significantly from what you find in the securities area, where all actions are public, and the consumer has the benefit of that knowledge when the consumer goes in to deal with the institution.

Senator PRYOR. Very good point.

Mr. Pollard, would you respond?

Mr. POLLARD. I have one point on one you made earlier. First of all, since 1991 in FDICIA, the Federal Deposit Insurance Corporation Improvement Act, all enforcement actions against banks are made public. I would hope that remedial actions are to the benefit of the consumer in any case.

You said it may not be good for the bank. I would like to just quote something, and we firmly believe in this. On this whole point of compensation referral, this is a direct quote from the investment sales guide that we put out: "Suitability, not compensation, should guide sales of nondeposit investment products. Banks are urged to cultivate a customer-oriented sales ethic—'If it's good for the customer, it's good for the bank.'"

So I won't disagree with your earlier point, but just say we're certainly not under any feeling that it's got to be good for the bank and bad for the customer. We feel it's a symbiotic, to use an old term, relationship. If it's good for them, it's good for us. And as I indicated, these sales of these products are at the same time that we would like to lend money to a customer, we'd like to have their regular deposits, we'd like them to have a credit card with us. Those relationships press on us.

In regard to surveys and studies, I know you said 20 percent. In addition to the Prophet survey, another survey has been done that I thought at least shows, again, we're going in the right direction. This is one that was prepared by Barry Leeds & Associates in New York. I'd be happy to make it available to the Committee. They

showed, going up from the 80 percent, that actually 89 percent of bank investment representatives orally disclose to customers that nondeposit products are not FDIC insured. Frankly, I don't consider—I mean, 89 means we've still got work to do, and that's what we're committed to doing, and that's what we hope to tell the Committee today.

Senator PRYOR. But wouldn't we know that if we had one little sheet there signed that said "This has been disclosed." Would that simplify things a great deal?

Mr. POLLARD. Absolutely.

Ms. CRAWFORD. Mr. Chairman, I might add that most of these studies have focused on larger banking institutions, as those are the ones who have entered into this business. However, we are beginning to see medium and small banks getting involved in the sales of uninsured products. They do not have the resources or the infrastructure to do the job that the bigger banks are doing, so we have concerns in that area.

And in addition, right now the only securities we're really talking about are mutual funds, which we all recognize are some of the more safe investments. What's going to happen when banks get into the business of selling, say, derivative investments? What is the confusion level going to be there? And if you have the combination of the small banks with limited resources and training ability and signage and the like combined with the offering of risky insurance or securities products, how is that going to impact older Americans?

Senator PRYOR. Good question.

Mr. POLLARD. Might I respond, Mr. Chairman?

Senator PRYOR. Mr. Pollard.

Mr. POLLARD. One of the comments—this goes to the earlier panel mentioning proprietary funds. I would note that in the guidelines—and as I said in my testimony, this is really an A to Z regulated activity. It really is. Banks are required and the examiners are required to substantiate why they pick particular funds. This is not just the bank opening its doors and saying to an investment rep, "Come on in and sell any mutual fund." They must have written policies of why mutual funds were selected that fit their types of customers in the banking institution. I think that's an important one that we have right up front. So it's both at the beginning of the process all the way to the compliance, as Scott was talking about, at the end. This is overseen and regulated.

Derivatives really is a subject that's not involved with retail customers. We just don't see that as something that—in other words, what I'm saying is we have both suitability for customers, but in a way we have suitability for banks as well. We require them to maintain written policies and carry them out with broad review why particular mutual funds were to be marketed in the institution.

I might add, if I could, for the Committee's record and note that the day before yesterday, before the Telecommunications and Finance Subcommittee of House Energy and Commerce, Mr. Lovett, the chairman of the SEC, indicated that the agency will put out a new risk-rating system and will reduce the amount of liquid investments that a mutual fund will take. He demands that mutual fund

directors take greater responsibility and be held accountable for fund investment decisions.

Now, what this means, Mr. Chairman, is that we expect much more disclosure and guidance for consumers on the mutual funds, similar—as you were saying, can you have a 1-page disclosure document. It may mean better risk rating of the mutual fund product.

Senator PRYOR. Good. Thank you very much.

Well, this has been a very educational hearing. I'm going to keep this record open for a matter of several days. I think that some of the statements given by this panel might want to be discussed, at least by letter to the Committee, by some of our previous witnesses. We would invite those letters to come forward if there are any areas where you would like to take exception or to add to your testimony.

I've just been informed by the bells—we live by the bells around here—that the Senate is now voting on the Department of Transportation's transportation bill, and because Arkansas has several projects in here, I better go over there and vote for it.

We want to thank all of you. This is the last hearing that the Aging Committee will conduct this year, and we have ended, I hope, on a very constructive note in an area and an issue that probably needs some more attention. We thank all of our panelists and our witnesses today. Thank you.

Our meeting is adjourned.

[Whereupon, at 11:50 a.m., the Committee adjourned, to reconvene at the call of the Chair.]

APPENDIX

CRS Report for Congress

Banks' Sale of Mutual Funds: Regulatory and Legislative Issues

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November 3, 1994

Congressional Research Service • The Library of Congress

ABSTRACT

In their continued movement toward greater product diversity, many commercial banks have begun selling mutual funds. Accompanying this bank involvement in mutual funds has been some concern that many bank customers do not understand that, unlike traditional bank financial products, mutual funds carry risk and are not federally insured. This report discusses two bills in the 103rd Congress, H.R. 3306 and H.R. 3447, that attempted to address this concern.

BANKS' SALE OF MUTUAL FUNDS: REGULATORY AND LEGISLATIVE ISSUES

SUMMARY

First organized in 1924, mutual funds initially grew very slowly. In 1940, there were 68 funds with assets of roughly $448 million, but by the 1980s and 1990s, as their popularity spread among the middle class, the funds grew tremendously and presently number about 4,500 with $2.0 trillion in assets.

Responding in part to the relative decline of their traditional "bread and butter" loan-making, banks have aggressively pursued other product lines over the past decade. An important part of their strategy has been selling mutual funds, a practice that has been aided by bank regulatory agency and court decisions that have whittled away at the Glass-Steagall Act's 60-year ban on bank involvement in various securities-related activities.

Bank involvement with mutual funds takes three basic forms: (1) The provision of space for selling "third-party funds," mutual funds which are managed by an independent mutual fund family; (2) retailing "private label" funds which are funds that are created and managed by an independent fund family but sold as the bank's exclusive "brand;" and (3) selling "proprietary" funds which are managed by the bank itself. About 30 percent of U.S. banks currently offer mutual funds; most do so through third-party or private label funds. About 100 banks currently sell about 1,100 proprietary funds.

As bank sales of mutual funds have proliferated, concern has grown that banks may not make their customers aware that unlike depository products, mutual funds can carry great risk and are not federally insured. In the 103rd Congress, H.R. 3306 attempted to address these misperceptions by among other things: (1) requiring that banks disclose to customers that nondeposit investments such as mutual funds pose investment risks and that they do not carry FDIC insurance; and (2) prohibiting bank tellers from advising customers or selling nondepository products like mutual funds. Bank regulators and the banking industry have largely opposed such legislation, maintaining that it is duplicated in recently issued bank regulatory agency and industry guidelines.

Another bill, H.R. 3447 would have shifted the regulation and oversight of the non-SEC-and non-NASD-registered bank personnel who are involved in the sale of mutual funds from bank regulators to securities regulators such as the SEC and the NASD. Banks would be compelled to place their mutual fund operations in a separate subsidiary under SEC regulation. The bill's supporters maintained that this *functional regulation* of such bank-based mutual activities would provide better investor protection due to the SEC's investor-oriented mission than do bank regulators with their "bank safety and soundness" institution-oriented mission. However, bank regulators such as the Federal Reserve claimed that exclusive bank regulator oversight of bank-based mutual sales is a key component of their ability to provide cohesive, unfragmented, and efficient overall bank oversight. This is known as *institutional regulation*.

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BANKS SALE OF MUTUAL FUNDS: REGULATORY AND LEGISLATIVE ISSUES

Bank involvement in the sale and sponsoring of mutual funds has paralleled both the decade-plus surge in the popularity of these retail investment instruments and the erosion in barriers to bank involvement with securities as mandated by the Glass-Steagall Act. This report examines the economics of the increasing bank involvement in the sale of mutual funds; growing concerns that investors in these funds are not being clearly informed of differences between traditional bank depository products and mutual funds; key bank regulatory initiatives in this area; key legislative initiatives; and emerging issues.

BACKGROUND ON MUTUAL FUNDS

Mutual funds are professionally managed pools of money that may be invested in domestic or foreign stocks, bonds, government securities, short-term money market instruments, futures, options, and collectible commodities. People who invest in mutual funds own proportional shares in the pool of investments which the mutual fund is invested in and they pay taxes on distributions received from such funds.

Also known as open-end investment companies, mutual funds provide for a continuous offering of new shares and the redemption of outstanding shares. When investors redeem their shares, a mutual fund's capitalization decreases, and when investors buy shares, the fund's capitalization increases. Mutual fund investors redeem or sell their shares back to the fund at the current net asset value (NAV).[1]

First organized in 1924, mutual funds grew slowly over their first several decades. By 1940, the year the Investment Company Act (ICA) was enacted, there were 68 funds with assets of roughly $448 million.[2] Due to particularly vigorous growth in the 1980s and 1990s, the funds now number over 4,500 with $2.1 trillion in assets according to the Investment Company Institute (ICI), the mutual fund trade association.

This growth derives from two broad developments: 1) asset capital appreciation (as the securities markets in which the funds were invested have generally boomed); and 2) the net sales of fund shares. Between January 1984 and July 1993, 43 percent of the $940 billion increase in equity, bond, and income funds was attributable to market appreciation, while 57 percent of the increase was the result of gains in the net sales of funds according to the ICI.

A pivotal impetus to the decade-and-a-half surge in mutual fund sales was provided by the introduction in the early 1980s, of money market funds (MMFs) invested in high-grade and highly liquid short-term assets, such as U.S. Treasury bills, large certificate of deposits (CDs) and corporate commercial paper. Thus, MMFs afforded small investors the opportunity to invest in these virtually risk-free and relatively high-yielding (because of interest rate ceilings at thrifts and banks) instruments which previously had been available only to the very wealthy.

MMFs proved to be such appealing investments in the early 1980s that,by 1983,taxable and tax-exempt MMFs accounted for about 75 percent of the net assets of all mutual funds. In many respects, the MMFs were responsible for providing the initial exposure of a large segment of the American public to the idea of investing in mutual funds. This growing familiarity with mutual funds combined with a rising stock market and falling interest rates led small investors to increase appreciably their holdings of long-term bond, equity, and income funds through the 1980s. While bond and equity mutual funds accounted for 3 percent of discretionary household financial assets in 1972, by 1993, they accounted for 16 percent of such assets. Accordingly, long-term funds grew from 450 in 1979 to about 3,300 by mid-1993.[3]

By 1992, mutual funds were owned by 27 percent of U.S. households, up from a 6-percent penetration in 1980.[4] It is an expansion that has been aided by other factors, one demographic and another involving the changing nature of U.S. retirement plans.

During the 1980s, many of the "baby-boomers" reached their middle-years, while many of the younger boomers became increasingly aware that aging is a factor to be reckoned with. Middle-age is often the time in the life-cycle of a worker when the household begins to embark serioulsly on retirement planning. It appears that, during the 1980s, there was a large and growing segment of the population in pursuit of well diversified long-term investments for their retirement years. Many of these investors have found that mutual funds meet these needs.

A related recent development is that of the steady shift by U.S. corporations from defined-benefit employee retirement plans to defined-contribution plans. Defined-contribution plans such as 401(k) plans allow companies to pass control of their retirement plans onto their employees. And, most 401(k) participants invest in mutual funds.[6] Currently, mutual funds account for about 18 percent of the $300 billion in defined-contribution-plan assets, and there are some predictions that this will grow to 27 percent by 1998.[6]

In concert with their growing salience as a household financial asset, mutual funds have become a much more integral part of the overall capital market. They greatly strengthened their role as financial intermediaries between corporate and governmental issuers of debt and equity and the individual and institutional investors who invest in them. Federal Reserve Board data show that, in 1992, mutual funds accounted for 86 percent of net purchases of equities; 20 percent of all net purchases of bonds; and 62 percent of net purchases of tax-exempt securities. These developments have prompted some financial market observers to characterize the recent ascension of mutual funds as one of the most profound financial market developments in years.[7]

THE STRUCTURE OF MUTUAL FUNDS

Mutual funds are defined by the ICA as publicly registered companies that have boards of directors (also called trustees -- depending on the particular legal requirements). The board holds responsibility for fund policy-making as well as selecting and monitoring of the fund's major contractors such as the investment adviser and the administrator or manager.[8] The ICA stipulates that each board contain at least 40 percent of directors who are disinterested individuals.[9] It is these disinterested board members who must approve the contracts that are arranged between the fund and the adviser, the underwriter, and frequently the administrator.[10]

Funds are started by their *sponsors* who usually act as initial shareholders and invest seed capital which is sufficient to capitalize the fund. In return, the sponsor receives a corresponding amount of the public shares in the fund. The amount of the sponsor's capitalization is usually $100,000, the necessary legal minimum for a fund to offer its shares to the public. The sponsor usually nominates both interested (inside or affiliated) board members and disinterested (outside or unaffiliated) board members, and the initial shareholder (generally the sponsor) elects the initial board. Once the first board has been elected, it may fill the vacancies that might develop between shareholder meetings. Actually, however, since most funds rarely have annual shareholder meetings and their boards exhibit little turnover, a fund's shareholders (investors) elect board members very infrequently.

The sponsor usually becomes the fund's investment adviser, or distributor and has been described as functioning "like a movie producer -- bringing together all the elements necessary for launching the fund."[11] In addition to recruiting directors to the board, sponsors often provide management and operational personnel for the fund and are charged with the identification of contractors who can provide the fund with auxiliary services.[12]

WHAT BANKS ARE ALLOWED TO DO WITH MUTUAL FUNDS

In 1933, in response to unprecedented bank failures in the early 1930s, Congress passed the Glass-Steagall Act, which effectively excluded banks and bank holding companies from securities-related commerce. Later, in 1940, Congress passed the Investment Company Act (15 U.S.C. 80a to 80a-52) and the Investment Advisers Act of 1940 (15 U.S.C. 80b to 80b-20)[13] which among other things decreed that only securities firms were to sponsor mutual funds.

However, over the last two and a half decades, liberal bank regulatory interpretations of Glass-Steagall and assorted court rulings have whittled away at proscriptions against bank involvement in mutual funds. These developments are essentially a subset of an overall haphazard evolution of the judicial and regulatory environment in which the Glass-Steagall's Act's goal of partitioning banks from general involvement in securities-related activities has been significantly, but not entirely eroded. Some banks or bank holding companies currently are involved in trading securities, providing brokerage services, underwriting commercial paper, municipal revenue bonds, and securities backed by mortgages or consumer credit.[14] Although Congress has considered, but not enacted, legislation that would have substantially amended the Glass-Steagall Act:

> . . . developments in the marketplace, court decisions and regulatory action have combined to erode the wall dividing the banking and securities industries. The major prohibitions remain more or less intact; banks are still barred from underwriting and proprietary dealing in corporate securities, while nonbanking firms are not allowed to operate banks. However, from the customer's point of view, the services offered by banks, brokers and other financial intermediaries are often interchangeable. Increasingly, this is true for commercial as well as retail, or individual, customers.[15]

In the pivotal year of 1972, the Federal Reserve began permitting bank holding companies and their nonbank subsidiaries to serve as investment advisers, transfer agents, and custodians to SEC-registered mutual funds.[16] More recently (1993), the Federal Reserve ruled that a bank holding company could also provide a full range of duties related to the roles of administrator or manager of mutual funds.[17] Although in 1992, the Federal Deposit Insurance Corporation (FDIC) permitted subsidiaries of State-chartered, nonmember banks to underwrite mutual funds, continuing interpretations of Glass-Steagall generally mean that nationally chartered and State-chartered Federal Reserve member banks cannot do so. Interpretations of Glass-Steagall also technically proscribe banks from technically sponsoring a mutual fund.

In the wake of the financial tumult and widespread losses experienced by the Nation's banks in the mid through the late-1980s, banks have recently started showing solidly profitable operations. Banks in 1992 garnered record earnings, large gains in capital ratios, and advances in the overall quality of their assets — advances that spilled over into 1993 and 1994.[18] Despite these encouraging recent trends, banks continue to experience historically weak demand for their "bread and butter" business in consumer and business loans. Federal Reserve analysts report that, adjusted for inflation, the value of aggregate bank loans actually fell between 1991 and 1993. Inflation-adjusted loan volume peaked in 1989 and had declined by 14 percent in 1993.[19]

In recent years, banks have launched several broad strategic responses to maintaining their profits and/or their market share in an apparent response to the recently moribund nature of their loan-making business. These include:

- increasing their holdings of U.S. Government securities;
- a growing involvement in providing fee-based services such as processing securities transactions, providing record-keeping services for pension funds, and managing corporate retirement plans; and
- expanding their participation in other fee-based services such as the marketing of mutual funds.[20]

Bank interest in the marketing of mutual funds has also been buoyed by the loss of deposits that banks have experienced in the 1990s. Their customers have sought higher returns, particularly when market interest rates fell significantly.[21]

THE ECONOMICS OF BANK MUTUAL FUND SALES

Bank involvement in mutual funds, the subject of this report, takes several basic forms:

- providing facilities for the retailing of "third-party funds" which consist of mutual funds managed by an independent mutual fund family. Most or all sales support is provided by the fund itself, while the bank receives fees or brokerage commissions for use of their facilities that are a proportion of the value of the funds sold.
- retailing "private label" funds that are generally established for a specific bank's exclusive use. Typically, the fund carries a name chosen by the bank and is known as an associate of the bank. The key role of investment adviser to the fund is generally performed by in-house fund personnel or an outside manager, but not the bank.
- providing "proprietary funds" which are mutual funds that a bank exclusively offers to its customers or other bank's customers and in which the bank serves the crucial role as investment adviser. To date, interpretations of Glass-Steagall have not allowed banks to play underwriter/sponsor or distributor roles, and bank managements hire unaffiliated firms to conduct these underwriting duties.[22]

DISINTERMEDIATION

Depending on the specific bank, its interest in any of the above-mentioned forms of retailing mutual funds can be rooted in a number of considerations. Some banks may see the surging market in mutual funds as a potential "cash cow" to be exploited as a part of the growing interest in fee-based income.[23] But, other banks are concerned that they are losing large numbers of depository-product customers to mutual funds, and have a compelling financial need to stanch the customer outflow by offering these competing products.[24] In short: mutual funds are thought to represent the kind of product diversification necessary for banks if they are to be viable players in the financial marketplace of the future in which the focus is projected to be on management of investments for consumers.[25] Still other institutions believe that the provision of mutual funds through banks may also have the spillover effect of generating new customers for banks' more traditional financial products. Interest in establishing a proprietary mutual fund in part may be driven by an attempt to capture economies of scale from existing investment advisory personnel and resources that serve banks' trust departments.[26] Finally, some observers have commented to CRS, that as with many other new financial market developments, some banks entrance into fund sales appears to be traceable simply to a "bandwagon effect."[27]

The overriding initial consideration for banks considering any of the tie-ins with mutual funds is probably the question of whether the added retail presence of the funds siphons off substantial numbers of a bank's base of traditional depository customers. This process is called disintermediation and appears to be an important part of the analytical consideration which banks often go through when considering whether or not to add new product lines.

In an article advising banks on the hurdles to be confronted when aligning themselves with mutual funds, Douglas Klinger, a vice president of the money management and mutual fund subsidiary of a major bank, observes:

> Disintermediation is difficult to discuss in a general way because sound data concerning product profitability, liquidity needs, and projected disintermediation costs for the banking industry as a whole are hard to come by. Every bank is different. . .
>
> The critical variable affecting profitability, and balance sheet liquidity is the "new money ratio" -- the ratio of new money going into your mutual funds from existing customers and customers of your bank and nonbank competitors, to disintermediated money. . .[28]

Some insight into the dynamics of bank mutual fund disintermediation can be gleaned from a March 1993 Federal Reserve study in which a number of bank finance officers estimated that between one-third and two-thirds of their mutual fund inflows originated from their institutions' deposits.[29] An official at the security firms of Shearson Lehman commented in 1990 that ". . . while some disintermediation is experienced by a bank shortly after its proprietary fund commences operation, deposits are typically replaced within a three-to-five month period." However, it is not clear what information this observation is based on and to what extent the more recent shifts in depository accounts to mutual funds may have dated the observation.[30]

There is, however, evidence which suggests that, over the last several years (as interest rates on bank products such as CDs fell), the banking industry witnessed an appreciable shift of those kinds of assets into long-term bond and equity mutual funds. For example, there are estimates that, between 1990 and 1993 about $350 million was shifted out of various bank accounts and into mutual funds.[31] In addition, there are estimates that roughly 15 percent of net new money pouring into stock, bond, and money market funds during 1992 and 1993 had previously been in banks.[32]

THIRD PARTY AND PRIVATE LABEL FUNDS

About 3,500 U.S. banks (out of a total of about 12,000 banks) currently offer mutual funds. The vast majority of them do this through one or both of the following vehicles: 1) the third party format in which mutual funds distributed by an independent mutual fund family are generally sold by fund personnel on the bank's premises; and 2) the private label format in which mutual funds are organized for a specific bank's exclusive use. Typically, the private label fund carries a name chosen by the bank and is known as an associate of the bank which provides retailing space and may or may not employ bank personnel to sell the fund. The important and often quite profitable role of investment adviser to the fund is performed by in-house fund personnel or an outside manager, but not the bank.

In the case of both third-party and private label funds, banks generally receive fees or brokerage commissions for providing retail space. These fees normally consist of a very small proportion of the total value of the funds that are sold. In the event that banks have brokerage subsidiaries conducting the sales, these subsidiaries receive sales commissions for funds sold.

The third-party and/or the private-label approach is a relatively inexpensive way of incorporating mutual funds into a bank's product line. Generally, these strategies offer banks an opportunity to be associated with name brand mutual fund families (in the third party approach), or they allow banks to benefit from the cachet of their "own" line of mutual funds (in the case of private-label funds). But, in spite of their low overhead (relative to proprietary funds), third-party and private-label funds may not be generally profitable. Information on their contribution to bank profits is not available, but some bank analysts contend that on balance banks may actually be losing money from retailing such funds. For example, Sanford Rose, editor of Retail Banking Magazine, and an associate of the consulting firm of Oliver, Wyman & Co., believes that, during the depressed earning period of the late 1980s and early 1990s, banks were particularly captive to short-term earning pressures. Thus, many banks were (and still are) willing to rent distribution space for other funds at rates effectively below their actual overhead costs when consideration is given to the fact that many of the banks have tended to underestimate their all-in costs (total costs, whether explicit or implicit) of distributing the funds from their branches.[33]

Generally the larger the bank (in terms of asset size), the greater the probability that the bank offers mutual funds. For example, according to one survey done by the Alliance Capital Management Company of New York City, 91 percent of banks with $1 billion or more in assets sell mutual funds. American Brokerage Consultants of St. Petersburg Florida reports that between a half and a third of banks with assets under $1 billion sell them.[34]

PROPRIETARY FUNDS

Proprietary funds are bank-sponsored funds in which the bank plays the critical role of investment adviser (also called manager) for mutual funds which they exclusively sell through their branch offices and/or through other banks. Currently, there are a little over 100 banks selling about 1,100 proprietary funds. This compares with the 59 banks that sold 213 proprietary funds in 1987.[35]

The last few years have seen tremendous growth in proprietary funds. Cerulli Associates, a Boston bank-consulting firm, reports that nearly 40 percent of today's proprietary funds were established in 1992 and 1993. Moreover, the historical domination of the proprietaries by tax-exempt and taxable money market funds is also undergoing some change. Cerulli Associates reports that between 1992 and 1993, the percentage of the proprietary assets held by these funds fell from 80 percent to 67 percent. Cerulli also reports that proprietary assets held by equity funds grew from 6 to 13 percent; taxable bond funds grew from 9 to 15 percent; and tax-free bond funds remained at 3 percent from 1992 to 1993.[36]

Numerous banks sell third-party funds, while waiting for their own proprietary funds to establish a credible performance record, an important investor draw. Setting up a proprietary fund is generally a much more costly endeavor than alignment with third-party or private-label funds. For a bank which is sponsoring its own relatively modest family of five funds, legal start-up fees can range from $750,000 to $2.5 million, with the structurally simpler money market funds tending toward the low range. Ongoing annual expenses have been estimated at a minimum of $150,000 a year, and can include expenditures for continuing legal advice; costs related to annual SEC registration; costs related to maintaining a board of directors; and costs related to contracting out distributor services and lesser responsibilities such as custodian, transfer-agent, auditor, shareholder, marketing, and custodial functions.[37] Funds try to recoup these fixed and ongoing expenses plus reap a profit margin through their shareholder charges.

Moreover, the rapid proliferation of competing mutual funds over the last several years has placed a premium on funds being able to provide their customers with prompt and convenient account information. The technology needed to facilitate this can add hundreds of thousands of dollars to a mutual fund's cost of doing business.[38]

Having sketched the cost structure of establishing a proprietary fund, the obvious question is: are proprietary funds making a profit? Unfortunately, this kind of information are not available. Still, by drawing upon scattered observations and insights culled from various analysts, some sense of the nature of proprietary fund profits may be gotten.

First, proprietary funds may allow banks to reap a handsome and continuous advisory (also called management) fee which is denied to banks that only market third-party or private-label funds. Lipper Analytical Services, a New York City-based mutual fund research firm, has estimated that the 110 banks with proprietary funds produced $350 million in gross revenue from advisory services in the first quarter of 1993 alone. Cost data on the provision of these services are not available, but some industry observers have commented that operational costs and particularly personnel training costs can be exceptionally high.

Generally, it appears that because of the significant fixed-cost component of running a mutual fund, a fund needs a sizeable asset size threshold and an attendant level of fees in the form of either sales loads or 12b-1 charges.[39] Depending on the observer, money market funds, the most common type of bank proprietary fund, are said to require minimum asset sizes of between $200 and $300 million to be profitable. Equity funds which benefit from larger management fees are said to require at least $75 to $200 million in assets for profitability, while bond funds (which also earn higher management fees than do money market funds) are said to need somewhere between a minimum of $125 to $200 million in assets for profitability.[40]

Bank proprietary funds on average are significantly smaller than are other funds of the same type. Average long-term (bond and equity) proprietary funds are less than half the asset size of the industry averages. Average proprietary money market funds, depending on whether they are tax-free or taxable, range between 55 percent and 70 percent of their overall industry averages.[41] Certainly, one of the factors behind the proprietaries' relatively small size is that they are also relatively new and have not had the time to grow as have the Nation's larger and generally older non-bank funds.[42]

Various industry observers cite the small size of proprietary funds as a major factor in the modest to bleak profit picture.[43] For example, one analyst has generally observed that proprietary funds exhibit marginal profits after paying for brokers and marketing and that even this profit is nearly exhausted by the time that a fund's "internal overhead" is factored in.[44] Kurt Cerulli (head of Cerulli Associates) observes that only about half of the 109 proprietary fund groups that he has counted appear to be profitable.[45] Moreover, the "smaller average size of bank mutual funds has generated some concern about the long-term viability of many smaller bank mutual fund groups."[46]

Additional factors which may militate against significant proprietary fund growth and profitability over the balance of the 1990s include:

- many banks were encouraged to establish proprietary fund families because investors have been attracted to the bullish stock market. However, with the recent cooling off of the market, these funds may find it harder to accumulate the critical mass of assets necessary for long-term survival;[47]

- a majority of the funds appear to depend significantly on seeding (beginning assets) through conversion of the managing bank's trust accounts, and not significantly through seeding via new, outside assets;

- many proprietary funds are also competing with third-party and private-label funds that are sold by the same bank;[48]

- a significant percentage of these funds are sold to institutional investors who are charged lower fees than those charged retail customers;

- the continued decline in the average size of front-load sale fees charged by mutual funds; front load fee structures are heavily used by bank proprietary funds;[49] and

- a widely held view that the rapid proliferation of mutual funds over the last decade has resulted in too many small and financially marginal funds, a situation that many suggest will become increasingly apparent as the current bull market cools off. Consequently, various observers project that the mutual-fund industry will undergo a shakeout which could include a large number of fund consolidations in the years ahead.[50] In this scenario, bank funds might cease to exist through either mergers with larger bank funds or non-bank mutual funds, or through liquidation.

Still, there are other characteristics or developments which could enhance the proprietaries' chances for survival in the coming years. These are:

- the existence of the banks' extensive branch network, an attribute which some observers characterize as an invaluable resource in providing marketing venues for mutual funds to the large banking public; and

- Mellon Bank Corporation's $1.85-billion acquisition of the Nation's sixth largest fund company, Dreyfus, is viewed by some as a harbinger of a new era in which banks vigorously acquire major mutual funds, providing the banks with funds that have exceptional size and encouraging economies of scale.[51]

CONSUMER CONFUSION CONCERNS AND GUIDELINES

As the bank marketing of mutual funds has grown, so has concern that some investors are not aware that the funds are nondepository products and are not risk free and federally insured as traditional bank depository products are. For example, a 1993 survey of 1,000 households done by the SEC found that 28 percent thought that all mutual funds sold through banks were insured.[52] Later, a March 1994 article in *Consumer Reports* summarized the results of a survey done by the magazine in which a reporter for the journal represented himself as a potential investor with $5,000 to invest. He met with sales representatives from 40 banks in States that included California, Connecticut, Illinois, New Jersey, and New York.[53] In many cases, the reporter found that he received "bad investment advice and outright lies about [the] safety [of mutual funds from loss of principal]."[54] The reporter also found many instances in which the bank guidelines that investment risks be disclosed and that customers be informed that mutual funds are not covered by FDIC insurance were being violated.[55]

BANK REGULATORY GUIDELINES

Federal bank regulatory agencies have responded to these observations of widespread investor misperceptions about the federally insured status of bank-marketed mutual funds. For example, the various Federal bank regulatory agencies[56] published separate guidelines to help their banks better address these potential informational shortfalls.[57] The guidelines shared a number of key provisions such as:

- banks should clearly disclose that money invested in mutual funds are not insured by the Federal Deposit Insurance Corporation (FDIC);

- the investments involve a element of risk and the principal invested runs the risk of being lost;

- banks must attempt to determine the suitability of such investments for their customers;

- tellers should not be involved in the marketing of mutual funds.

However, these guidelines contained sufficient conflicts and differences to provoke criticism, including that of John Dingell, Chairman of the House Energy and Commerce Committee.[58] Subsequently, on February 19, 1994, the banking agencies issued a joint interagency statement intended to supersede the earlier separate statements. It provided a uniform and standardized set of bank guidelines.[59] The guidelines emphasize the centrality of customers' interests as banks conduct their mutual fund operations, noting that the Federal banking regulators will take appropriate action to address unsafe and unsound banking practices and violations of law and regulations associated with the sale of mutual funds. Major provisions of these guidelines are:

- Bank personnel should disclose orally during sales presentations in writing before or when a mutual fund account is opened and in all related advertising that: 1) the mutual funds are not insured by the FDIC; 2) the mutual funds are not a depository product guaranteed by the bank; and 3) that the funds are subject to investment risk and potential loss of principal;

- Bank personnel should disclose the existence of a commercial relationship (such as that of fund advisor) between the bank or an affiliate of the bank and the mutual funds being marketed;

- Except in very limited situations (where physical conditions prevent it) recommendations or sales of mutual funds should be done in physical locations that are distinct from the area in which insured deposits are made;

- Tellers and other bank personnel who work in deposit-taking areas of the bank should not make investment recommendations or accept orders for mutual funds; and tellers and other bank employers who are not authorized to sell nondepository products such as mutual funds are only allowed to refer customers to personnel who have been trained to sell them;

- Bank personnel who sell or provide investment advice on mutual funds should receive training that is substantially equivalent to training necessary for securities brokers who are licensed by the National Association of Securities Dealers (NASD);[60]

- Bank personnel who recommend mutual funds to customers should make a reasonable effort to obtain information on a customer's financial and tax status and any other related data, and then use the information to advise the customer on the suitability of such investments;

- A bank should not offer mutual funds with a name that is identical to that of the bank; and banks which offer mutual funds with similar names are warned about the risk of offering such products due to the prospect that the customer may be confused;

- Bank personnel, including tellers, can receive a one-time nominal fee of a fixed-dollar amount for each customer referral for mutual funds, and this referral fee should not be contingent on whether the referral results in a transaction. Personnel authorized to market mutual funds may receive incentive compensation like commissions for customer sales, but these must not be structured so as to result in unsuitable recommendations and/or sales.

In late February 1994, Office of the Comptroller of the Currency (OCC) officials reported that there did not appear to be serious violations of the guidelines, but they noted that some banks were still failing to inform customers that mutual funds lacked Federal insurance. Branches farthest away from bank headquarters were reported to be more prone to this kind of consumer negligence. In addition, a number of cases in which bank compliance officers (who are charged with ensuring that banks comply with bank regulatory rules and guidelines) were observed directly reporting to bank sales manager, a potential conflict-of-interest situation. However, generally, OCC officials observed that bank personnel were directing investors to suitable investment products.[61]

To help bank and securities regulators monitor banks' sales of mutual funds on an ongoing basis, Comptroller of the Currency Eugene Ludwig proposed that "mystery shoppers" pretending to be prospective investors be sent to bank branches to ascertain whether bank personnel are adequately communicating the risks and uninsured nature of nondepository products such as mutual funds. In April 1994, OCC officials presented the mystery shopper plan to the SEC, the FDIC, the Fed, and OTS in the hope of mounting a joint regulatory effort. So far, the other agencies have been cool to the joint effort; Fed Governor John LaWare cited concerns about the appearance of a "witch-hunt." Meanwhile, the FDIC is beginning a mystery shopper program of its own for the banks that it regulates, and OCC officials indicate that the agency may decide to conduct a similar program.[62]

As a whole, banking regulators and bank trade groups such as the American Bankers Association (ABA) look at the joint guidelines as a substantive and meaningful regulatory development. Moreover, the existence of the guidelines is cited as a central reason why additional legislation concerning bank marketing of mutual funds is presently unnecessary.[63]

However, others have been much less sanguine about the efficacy of the interagency guidelines. House Energy and Commerce Committee Chairman John Dingell, and SEC Chairman Arthur Levitt, Jr., have attacked the guidelines for being merely advisory and thus legally unenforceable.[64] Chairman Dingell's has also criticized the guidelines for being so generally worded that they afford banks great latitude in promulgating the procedures and policies necessary to put them in effect.[65] Comptroller of the Currency Eugene Ludwig has responded that the guidelines effectively constitute a mandatory set of standards that, if breached, could result in rapid enforcement action by bank regulators.[66]

More specific criticism concerns the absence of mandated examination and disciplinary programs for bank securities personnel like that which the NASD provides for its member broker-dealers. (The interagency guideline say that bank personnel who sell or provide investment advice on mutual funds *should* receive training that is substantially equivalent to that which is done for securities brokers who are licensed by the NASD.)[67]

According to OCC figures, roughly 90 percent of all bank-based mutual fund sales are done by non-bank personnel, typically through lease arrangements with third-party broker-dealers selling non-proprietary funds on bank property. The practices and products of these dealers are regulated under the principal mutual fund regulatory statute, the Investment Company Act of 1940. As such, these dealers and their practices fall under SEC, not bank, regulation and are also subject to NASD oversight, including its licensure and examination requirements.[68]

Comptroller of the Currency Ludwig has acknowledged that the residual 10 percent of bank-based mutual funds sales are conducted by bank personnel marketing bank proprietary funds that are not subject to NASD oversight and testing.[69] In early 1994, the OCC asked the NASD to test these bank-based fund salespersons, and in September, Comptroller Ludwig announced that the OCC had reached an agreement with NASD to open its exam to bank employees. Details of the proposed testing are being worked out by the OCC, the Fed, the FDIC, OTS, the New York Stock Exchange, and the NASD. It is currently envisioned as non-mandatory testing to go into effect some time in 1995.[70]

Additional criticism has been leveled at other aspects of the interagency guidelines. For example, the director of Banking and Housing Policy at the Consumer Federation of America (CFA), a consumer advocacy group, criticized a provision in the interagency guidelines that supports the use of promotional brochures and advertising containing information on both insured and uninsured products (such as mutual funds) as long as the information is "clearly segregated." The CFA official commented that the idea of clear segregation is subject to an individual bank's interpretation and in certain cases might be construed to mean as little as a two-line separation between the section on the bank's insured products and the section on uninsured products like mutual.[71]

The CFA has also criticized the guidelines for allowing bank personnel including tellers to receive a fee for each customer referral for mutual funds. The consumer organization's concern is that the fee might promote bank personnel to refer customers to products that may be inappropriate for the customer's particular investment portfolios.[72]

JOINT BANK TRADE ASSOCIATION GUIDELINES

In February 1994, in a parallel development to the issuance of the joint interagency guidelines, six bank trade associations (the American Bankers Association, the Bankers Roundtable, the Consumer Bankers Association, the Independent Bankers Association of America, the National Bankers Association, and the Savings & Community Bankers of America) issued joint guidelines designed to direct their member banks in the proper procedures for retailing mutual funds and other nondeposit projects. Entitled *Retail Investment Sales, Guidelines for Banks*, the guidelines are an unusual, collective effort by the banking trade groups and are designed to complement the earlier group of bank regulatory guidelines that were issued throughout 1993.

The banking trade group's guidelines were reportedly put together with the guidance of the various bank regulators and are said to "reiterate and emphasize" bank regulatory guidelines on the bank retailing of uninsured products.[73] The guidelines advise banks on the proper retailing of such uninsured products in areas such as full disclosure of risk and lack of insurance; advertising and promotion; location; the training of product salespersons; and employee compensation and referral fees.[74]

THE NASD GUIDELINES

In June 1994, the NASD announced it was going to issue comprehensive guidelines to brokerage firms that sell through banks (whether or not the firms are affiliated with a bank). The broker-dealer self-regulatory organization (SRO) guidelines provide a road map for proper practices on the part of bank-based NASD registered brokers and nonlicensed bank personnel involved in the sale of mutual funds. Described as basically similar to the bank regulators' interagency guidelines, the NASD guidelines do contain some differences.

For example, the guidelines advise brokerage firms to provide non-licensed personnel like bank tellers with a manual of "do's and dont's." While also advising that depository personnel be permitted to receive a one-time fee for referring customers to sales personnel, the NASD guidelines proscribe the receipt of other forms of compensation such as monetary awards, free meals and trips. In addition, the guidelines recommend that branch bank representatives not sell a bank's own debt instruments to branch customers, but the guidelines do allow the unsolicited sale of a bank's stock to customers who make such a request. Some bank officials call the NASD guidelines a welcome development as it had previously not been completely clear exactly what the SRO wanted in some of these areas.[75]

CONSUMER CONCERNS AND PROPOSED REMEDIAL LEGISLATION

H.R. 3306

H.R. 3306, the Depository Institution Retail Investment Sales and Disclosure Act, would amend the Federal Deposit Insurance Act and was introduced on October 19, 1993 by Henry Gonzalez (D. Texas), Chairman of the House Banking, Finance, and Urban Affairs Committee, and Representative Charles Schumer (D. N.Y.) H.R. 3306 represented a legislative response to concerns that the growing market in the bank sale of mutual funds is fraught with sales policies that have resulted in widespread investor misinformation and confusion over the uninsured nature and the riskiness of the mutual funds. These are perceptions that the bill's sponsors' think have been significantly fueled by the failure of numerous banks to communicate clearly to their customers that the funds bear none of the risk-free, federally insured attributes that banks' conventional insured investment products possess.

The major provisions of H.R. 3306:

- Prohibit any insured depository institution from permitting any person to engage in any practice or advertising which could mislead a customer as to: (1) the uninsured nature of any nondeposit investment product offered or sold by the institution; or (2) the investment risk associated with such product.
- Require specific disclosure to potential customers, including disclosure that the nondeposit investment product is not insured by the FDIC and that the product poses investment risks and may involve the loss of principal. In this context, it also requires the investor who purchases such a nondeposit product to sign a declaration acknowledging their awareness of the disclosures.
- Prohibit an insured depository institution from allowing any personnel who accept deposits from selling or offering investment advice on any nondeposit investment product. However, upon customer request such personnel are permitted to refer customers to the appropriate sales personnel, provided that they do not solicit the request for referral; receive no referral compensation; and disclose that the product is not FDIC insured.
- Prohibit persons involved in bank-related sales of mutual funds from providing investment advice on nondeposit investment products in any part of the bank or on behalf of the bank unless such person is registered with the SEC as a broker, representative of a broker, or investment adviser or meet qualifications or training requirements that the banking regulatory agencies determine are equivalent to those applicable to such a registered person. Training of sales personnel shall include education in making an accurate judgment about the suitability of a particular nondeposit product for a prospective customer.

- Prohibit an insured depository from using any part of its space for selling or providing investment advice relating to any mutual fund or nondeposit product, unless these service areas are physically segregated from the part of the office where deposits are taken or withdrawn.
- Prohibit banks and/or their affiliates from using or permitting the use of the bank's name, title, or logo or any word or design that is similar to or a variation of the bank's name, title, or logo in connection with any mutual fund for which the bank or the affiliate acts as investment adviser. The name restriction would also apply to any nondeposit investment product offered for sale by the bank, its affiliate, or by any person at the bank's office.
- Require the federal banking agencies to establish minimum standards to ensure that compensation does not result in the sale of nondeposit investment products in lieu of more suitable investment options for their customers.

Representative Charles Schumer observed that H.R. 3306 is intended to see that the ". . . full disclosure message that banks must deliver about non-insured investment products must not be undercut by conflicting information that tends to reinforce presumption of deposit insurance."[76] And, insisting that regulatory and industry initiatives have been ineffective, Representative Schumer observed:

> . . . "voluntary" guidelines issued by banking regulators and industry group are simply not up to the job. Customer confusion persists. The distinctions between insured and uninsured products are being blurred.[77]

The Fed and the OCC have both commented that provisions of H.R. 3306 are essentially mirrored in the series of guidelines (including the interagency guidelines) that the agencies have issued on bank retailing of nondeposit products, thus rendering the legislation unnecessary. Spokespersons for the American Bankers Association (ABA) have also taken the position that H.R. 3306 is basically duplicative and argue that it is thus unnecessarily burdensome.[78]

OTS officials have also stated that most of the provisions in H.R. 3306 provisions are already mandated by the agency through its regulation, guidelines, policy statements or interpretations. Nonetheless, OTS officials have taken pains to identify a number of areas in which OTS policy and H.R. 3306 are at significant variance. These differences which OTS officials say bear further consideration and analysis, generally relate to distinctions between the interagency guidelines (which the Federal Reserve, the OCC, OTS and the FDIC were signatories to) and H.R. 3306.[79] These differences include:

- Fund names. The interagency guidelines proscribe fund names that are identical to the retailing bank or affiliate. H.R. 3306 goes farther and prohibits even similar names.
- Referral fees. The interagency guidelines allow bank personnel involved in selling or offering investment advice to receive one-time compensation for referring customers to bank-related investment advisers and/or brokers. H.R. 3306 prohibits such compensation.
- Locale. The interagency guidelines requires banks to make office space devoted to depository taking and withdrawal *distinct* from the space that they devote to nondepository products. H.R. 3306 requires *physical segregation* of the operations.
- Confidentiality of customer information. The interagency guidelines allow banks to make their own policies (subject to applicable laws) on whether to require customer consent before the customer's confidential financial records are provided to other entities such as an affiliate of the bank. H.R. 3306 requires that bank customers provide consent before their financial records are provided to other entities.

On the latter issue, the confidentiality of customer information, OTS officials have observed ". . . the customer information issue is particularly difficult. Targeting certain customers for certain products is an efficient marketing strategy used by many entities. On the other hand, it is appropriate that such information not be used inappropriately to take advantage of customers."[80]

By contrast, spokespersons for the North American Securities Administrators Association (NASAA), the national organization of the 50 State securities agencies, have strongly advocated an outright prohibition on bank sharing of customer information with any securities affiliate:

> . . . financial institutions routinely are sharing with securities salespersons what commonly is considered confidential information about the customers finances, including the maturity dates of these CDs. It is clear that banks are supplying this information to brokerage operations in the hope of persuading bank customers to purchase uninsured investment products with the funds earned when CDs have been cashed in.[81]

Meanwhile, officials at the FDIC have observed that much of the thrust of H.R. 3306 is addressed in the interagency guidelines, but they have criticized the legislation for a prescriptive and inflexible approach to these issues. The officials have asserted that allowing bank regulators and the banking industry to evolve a set of solutions flexibly over time is a more efficient course of action.[82]

For example, H.R. 3306 would require the bank regulatory agencies to establish minimum standards to ensure that bank compensation does not result in the sale of nondeposit investment products in lieu of more suitable investment options for their customers. FDIC officials charge that this kind of standard-setting imposes rigidities that could conflict with market realities in which bank employees are generally compensated through salaries whereas sales persons in the securities and insurance industries have more commission-oriented compensation arrangements.

The FDIC officials note that if bank personnel receive commissions for selling securities, but not for overseeing the opening or the renewal of customers' depository accounts, conflicts may arise. However, the officials have also observed that it is unrealistic to expect bank-based securities or insurance personnel to be compensated in ways that are at odds with industry norms. Overall, their concern is that these compensation considerations are so complex that within legal parameters and safety and soundness considerations, banks should be allowed to devise their own compensation schedules as freely as possible.[83]

Another contentious provision in H.R. 3306 related to fund names. ABA representatives have explicitly criticized the provision in H.R. 3306 that would prohibit banks and/or their affiliates from using or permitting the use of a bank's name, title, or logo or any word or design that is similar to or is a variation of the bank's name, title, or logo in connection with any mutual fund for which the bank or the affiliate acts as investment adviser.[84]

ABA spokespersons argue that as in the case of other types of financial services that are allowed to name their affiliate banks similarly (such as Merrill Lynch Funds which are affiliated with Merrill Lynch Bank and Trust), banks should be allowed to continue the same potentially enhancing kind of branding. The ABA opposes fund use of an affiliate bank's identical name, however. For example, it would oppose Antarctica Bank's Antarctica Bank Funds, but would support the label of Antarctica Funds. When similar names are used, it would advise banks to make "increased customer disclosures" that the mutual fund products are not FDIC insured.[85]

Consumer and investor advocates such as the CFA and NASAA are opposed to the use of similar sounding affiliated funds, arguing that this increases the likelihood of customer confusion over the differences between the banks' insured products and the funds' uninsured investment offerings.

The SEC has identified 42 banks that have employed some form of a bank's name as a part of mutual funds that they market. Some examples of larger bank funds that carry names similar to their affiliate banks are PNC Funds (PNC Bank), NationsFunds (NationsBank) and Wells Funds (Wells Fargo).[86] The practice in which mutual funds carry an identical or names similar to their affiliated bank has been criticized for furthering the prospect that investors may confuse the fund products with insured investment products. But, various banking industry insiders emphasize that this "branding" constitutes an effective form of marketing.

Bank regulatory agencies have generally looked askance at such practices. The Fed has prohibited banks under its jurisdiction from using corporate names on mutual funds, however, few Fed regulated banks sell proprietary or private label mutual funds. In April 1993, the OCC urged banks to avoid using such names, but it did not specifically proscribe the banks that it regulates from doing so. The February 1994 interagency guidelines proscribe the use of identical names, but allow bank affiliated funds to use names that are similar to their affiliate banks.

H.R. 3447

H.R. 3447, the Securities Regulatory and Equality Act of 1993, was introduced on November 9, 1993 by House Energy and Commerce Committee Chairman John Dingell.

Key features of the bill:

- Amend the Securities Exchange Act of 1934 to include within its broker-dealer definitions most bank securities activities and require that such activities be moved into separate subsidiary corporate entities. As such, most bank securities operations would fall under the regulatory domain of the SEC and the NASD.
- Amend the Investment Advisors Act of 1940 to include banks that advise registered investment companies' mutual funds. As such, a bank that advises a registered investment company would be under SEC regulation as are other investment advisors to investment companies.
- Prohibit mutual funds that are advised by banks from using the same name as or a name similar to the affiliated bank.
- Generally prohibit an investment company from knowingly acquiring a security during an underwriting if the proceeds from the acquisition are to be used to retire any part of an indebtedness owed to a bank that is affiliated with the investment company. Also, prohibit investment companies from borrowing money from a bank which they are affiliated with.
- Prohibit a bank from both serving as an adviser to an investment company and owning a controlling share in that company in its capacity as trustee for shareholders of the company, except as permitted by SEC rule or order.

H.R. 3447's overall goal is to replace the essentially *institutional regulation* now prevailing over bank securities activities, which are under the ambit of bank regulators, with *functional regulation* of bank securities activities. With *functional regulation*, the SEC and the NASD would regulate these specific activities conducted in banks. (See box 1 for a brief discussion of the pros and cons of the two approaches.)

Arguing for H.R. 3447's functional regulatory sweep, the bill's sponsor, Chairman John Dingell invoked the spectre of the large-scale losses experienced by the savings and loan industry — losses that he contends were significantly the result of inadequate regulation of those depository institutions:[87]

> Although banks have dramatically expanded their brokerage and investment activities, the SEC is presently powerless to regulate them as either broker-dealers or investment advisers. Right now banks do not have to register as such with the SEC if they engage in brokerage activities or provide investment advice to customers. They also are exempted from the registration and reporting requirements of the Federal Securities laws when they offer their own securities to the public. Finally, they are not subject to the sales practice rules that are critical to the protection of investors. Clearly the securities activities of banks fall between the cracks in our regulatory system. That is of particular concern when taxpayers confront a $150 to $175 billion tab for the savings and loan crisis, thanks largely to inadequate regulation.
>
> The lack of proper regulation not only causes substantial potential regulatory disparities, but presents grave potential danger to investors, who may well assume that a security sold to them by a bank is federally insured. Our bill addresses the investor protection concern currently posed by unregulated bank sales of securities to the public. Our bill will close the regulatory gap that currently exists, to the detriment of the American public. . .[88]

Functional regulation is directed at multi-party enterprises inasmuch as its underlying tenet is that like kinds of activities in any sort of form should be subject to regulation by a single agency. It contrasts with *institutional regulation* whereby a single regulator would look at the various facets - whatever they might be - of a business enterprise. Functional regulation is often seen as a better means of accommodating the diverse nature of organizations that might be in the banking business . . .

Advocates take the view that the functional approach to regulation would assure that all firms engaged in an activity are subject to the same rules, enforced by the same regulator. As regulation is administered now, different banks have different primary Federal regulators. Depending on the banks chartering arrangements current practices can lead to differences in treatment on some matters. . .

At the same time, it can be argued that regulation by function might not be an improvement over regulation by type of institution, since diversified companies still could be subject to a multiplicity of regulators. According to this view, regulation by function could lead to the same sorts of issues traditionally associated with the desegregated approach to regulation of depository financial institutions — those of overlap, duplication, gaps and conflicts.*

* U.S. Library of Congress. Congressional Research Service. *Bank Regulatory Agency Restructuring Under Expanded Powers: Some Alternatives.* Report No. 90-552 E, by F Jean Wells. Washington, 1990. p. 5-6.

SEC Chairman Arthur Levitt has testified to the agency's support for functional regulation and H.R. 3447, noting that:

> While bank affiliates and subsidiaries that engage in securities activities must register with the Commission like any other broker or dealer, banks that engage directly in securities activities continue to be exempt from broker dealer registration. . . This unique treatment afforded bank securities and mutual fund activities also stands in contrast to the regulatory schemes for bank municipal and government securities activities which are regulated under the Federal securities laws. . . the continued existence of a separate regulatory scheme for banks makes little sense in an era of regulatory consolidation. . .[89]

Chairman Levitt also argues that because the banks' role in the securities markets probably will continue to grow, an increasing number of securities customers will be receiving less protection -- absent functional regulation.[90] More specifically, the SEC chairman has charged that bank regulators should not be overseeing bank mutual fund sales because their concern is over institutional *safety and soundness* as opposed to the SEC's objective of *investor protection*.[91]

Taking issue with Chairman Levitt's premise, Comptroller of the Currency Eugene Ludwig has responded that consumer protection and customer satisfaction are inextricably tied to the bank regulatory mission of maintaining a safe and sound bank. Moreover, even in the absence of bank regulatory oversight of mutual fund sales, Mr. Ludwig has argued that bank regulators will still be responsible for the operational and legal aspects governing bank safety and soundness; the SEC's presence would add another level of bureaucracy.[92] He has also argued that unlike institutional regulation, functional regulation risks missing the constellation of intricate and disparate interactions that are ongoing within banks and that change over time.[93]

Governor John LaWare, speaking for the Federal Reserve, has echoed Comptroller Ludwig's negative views on H.R. 3447. For example, in speaking of the Fed's opposition to functional regulation as outlined in H.R. 3447, Governor LaWare challenged Chairman Dingell and SEC Chairman Levitt's contention that the SEC's investor protection mandate provides better protection from deficiencies than does the bank regulators' concern with bank safety and soundness. Governor LaWare asserted that bank safety and soundness requires that bank customers and bank product investors have confidence in the banks. If bank regulators do not protect the interests of these bank consumers, their confidence in the bank will be undermined and ultimately bank safety and soundness will erode, he contends.[94]

On the issue of bank regulators' ability to use enforcement muscle to stop problems involving the bank sale of mutual funds, Comptroller Ludwig testified of the OCC's willingness to use the statutory authority which allows bank regulators to issue cease and desist orders as well as other actions.[95] Also, Mr. Ludwig repeatedly asserted that the interagency guidelines constitute a set of mandatory standards that if violated *could* also prompt bank regulatory enforcement action.[96]

Spokespersons for the ABA have rejected the thrust of H.R. 3447, asserting that the organization would not embrace functional regulation and thus would reject SEC oversight of bank sale of mutual funds because of the additional regulatory costs that these would entail.[97] Speaking for the ABA during hearings held by the House Energy and Commerce's Oversight Subcommittee, R. Scott Jones projected that H.R. 3447 "would make banks and bank holding companies non-competitive in a wide range of wholesale and retail securities activities."[98] Mr. Jones, a member of the ABA board of directors, has also reiterated the trade association's longstanding view that it would not accept functional regulation unless the Glass-Steagall prohibitions on bank securities underwriting were removed. The view is shared by Governor LaWare of the Fed and hinges on the idea that if banks are to be regulated like securities firms, then they should be allowed to have all the powers that securities firms have.[99]

Spokespersons for the Independent Bankers Association, an association of community banks, have attacked H.R. 3447 for adding additional regulatory costs that "could unnecessarily keep small banks out of the business of [selling proprietary mutual funds] and [thus] prevent them from adequately serving their customers."[100] Fed Governor LaWare has amplified this view observing that many small bankers would discontinue offering mutual funds if they had to face H.R. 3447's additional regulatory costs and paperwork.[101] However, unlike the ABA, IBA spokespersons have stated that the group is not willing to embrace functional regulation in exchange for expanded securities powers such as securities underwriting. This is primarily because the smaller community banks are said to have little interest in entering full-line securities underwriting -- unlike many large banks.[102]

Supporters of H.R. 3447 have argued that because of their differing histories and obligations, the SEC and the bank regulators have taken disparate approaches to the enforcement of Federal securities and banking laws. A central illustration of this disparity is said to be the fact that bank regulators tend to minimize public disclosure of their enforcement action against banks. The agencies publicly disclose final orders in connection with enforcement proceedings, but the releases do not normally contain information on the type of violation and the specific enforcement actions undertaken.[103] By contrast, the SEC's enforcement program is characterized by much more "aggressiveness" in informing the public of enforcement actions taken under the various Federal securities laws. For example, disciplinary hearings are not only a matter of public record, but also result in press releases that describe the nature of the proceedings and the names of the parties who have been disciplined. Moreover, under the mandate of Federal securities law, the NASD provides a toll-free number which allows interested investors access to information on the "disciplinary and civil liability records of broker-dealers' registered representatives."[104]

H.R. 3447's proponents also contend the SEC has been more institutionally inclined to promulgate strict rules of general behavior (with the agency able to exempt only appropriate cases). This is said to contrast with bank regulators emphasis of achieving their goals through a guideline oriented approach that gives the individual banks certain latitude in devising their own approaches to the goals.[105]

The legislation's supporters also question whether bank regulators are as institutionally disposed to implementing severe enforcement actions when appropriate, as the SEC has done in its disciplinary actions against brokerage firms like Drexel Burnham Lambert and Prudential Securities.[106]
Examples of the SEC's reported bent for aggressive enforcement have been contrasted with bank regulators comparatively lax enforcement tendencies as illustrated in a 1994 GAO study, *Bank Inside Activities: Insider Problems and Violations Indicate Broader Management Deficiencies.* The GAO study reportedly looked at the nature of bank regulators' enforcement of "insider violations."[107] It concluded that "the regulators may have been able to take stronger enforcement actions, considering that 126, or 72 percent [of the detected bank inside violations studied] had repeated insider violations."[108]

H.R. 3447's proponents such as the Investment Company Institute (ICI), a mutual fund trade association, and Edward Markey, Chairman of the House Energy and Commerce's Subcommittee on Telecommunications and Finance have noted that the activities of bank-advised funds (and other bank activities) are subject to often duplicative and inconsistent regulation by the various bank regulatory agencies.[109] In contrast, the activities of the mutual fund industry outside of bank-advised mutual funds (the legislation's primary focus) are the subject of a uniform set of standards that have been adopted and enforced by the SEC and self-regulatory organizations like the NASD. Comptroller Ludwig has gone on record in support of the Clinton Administration's controversial plan to consolidate the four bank regulators in order to reduce the costs of banks complying with the overlapping and at times inconsistent multiple bank regulators. Chairman Markey and the ICI have accused Comptroller Ludwig of being inconsistent in supporting this consolidation, but opposing the regulatory consolidation of all mutual fund securities activities as called for by H.R. 3447.[110]

BANK HOLDING COMPANY BAILOUTS TO PROPRIETARY FUNDS AND THE CONTINUED DEBATE ON H.R. 3306 AND H.R.3447

While the debate over H.R. 3306 and H.R. 3447 was going on in the 103rd Congress, at least seven bank holding companies with proprietary money market funds "bailed out" those funds when the funds' investments in particular types of financial derivatives (financial products whose value is derived from other financial products) began declining in early 1994 when short term interest rates rose. The bank holding company bailouts (two examples are Wilmington Trust and Bank of America) which were not legal obligations, accompanied a number of mutual fund bailouts of non-bank based money market mutual funds because of derivative losses as well. The SEC, which oversees the activities of all mutual funds, but not the activities of their bank advisers, invoking standing securities laws is requiring that all of the money market funds divest themselves of such assets.[111] And, the Federal Reserve has reported to Chairman Gonzalez of the House Banking Committee that the bank holding company bailouts did not threaten the safety and soundness of the holding companies.[112] These developments will be the subject of an upcoming CRS report.

Still, the bank proprietry fund bailouts have had an unsettling effect in parts of Congress and the financial community.[113] Assuming that debate on bills such as H.R. 3306 and H.R. 3447 continues in the 104th Congress -- such a debate may also need to incorporate the concerns raised by these developments.

[1] Current net asset value is the per share value of a fund's assets which is computed by subtracting liabilities from the portfolio value of securities held, plus cash and accrued earnings and then dividing that total by the number of outstanding shares. This represents the dollar amount that all shareholders would receive if they all redeemed their shares of the mutual fund.

[2] The Investment Company Act of 1940 (ICA), requires companies that market pooled investment funds to the public to register as investment companies with the Securities and Exchange Commission. In addition, the ICA sets standards for disclosure of financial information, pricing of fund shares and the allocation of portfolio investments.

[3] Mack, Phillip. Recent Trends in the Mutual Fund Industry. *Federal Reserve Bulletin*, p. 1008-1011.

[4] Clark, Michelle. Banks and Investment Funds No Longer Mutually Exclusive. *St. Louis Regional Economist*, October 1993. p. 6.

[5] Defined-contribution plans are any number of savings plans that allow employers and employees to make periodic contributions on a tax-deferred basis for retirement income. Defined-benefit plans are retirement income plans set up by an employer to pay a specified sum to qualified employees, based on the number of years of service. A 401(k) plan is a type of defined-contribution plan that allows employees to contribute up to specified percentage or amount of pretax dollars to an investment pool managed by the employer.

[6] Laderman, Jeffrey and Geoffrey Smith. The Power of Mutual Funds. *Business Week*, January 18, 1993. p. 68.

[7] Kuhn, Susan. The New Perilous Stock Market. *Fortune*, December 27, 1993. p. 49.

[8] Investment advisers (also called fund mangers) are hired to make decisions about a fund's securities investments in accord with the fund's general objectives. They oversee the day-to-day fund management and decide on prudent investment strategy for a fund's portfolio in light of overall goals. Advisers also conduct financial research for their funds. Advisers are normally compensated based on a percentage of the fund assets that are under management. However, some advisers have compensation which is dependent on fund performance relative to established benchmarks. Transfer agents maintain shareholder ownership, records and process orders for sales and redemptions. Custodians settle securities transactions, hold the securities, collect the income due, and are responsible for all the securities and the cash owned by the fund.

[9] Disinterested persons are individuals who: are not affiliated with the investment adviser; are not affiliated with any person that the SEC has identified as having a material business or professional relationship with the fund; are not affiliated with any employee or officer of the fund; and are not affiliated with any registered broker or dealer or any other persons with interests or affiliations with the fund.

[10] Fund underwriters are registered brokers under the Securities Exchange Act of 1934 and are responsible for all the transactions within a fund. When an investor wants to acquire or sell shares, the underwriter deals directly with the fund and then finalizes the transaction with the particular investor. Consequently, as a technical matter, the underwriter momentarily owns every share of security that is purchased or sold by the fund.

[11] Schonfeld, Victoria and Thomas Kerwin. Organization of a Mutual Fund. *Business Lawyer*, November 1993. p. 108.

[12] Ibid., p. 108.

[13] The ICA requires companies that market pooled investment funds to the public to register as investment companies with the Securities and Exchange Commission. In addition, the ICA sets standards for disclosure of financial information, pricing of fund shares and the allocation of portfolio investments. The Investment Advisers Act requires that persons making buy or sell recommendations to clients who hold themselves out to be investment advisors must register with the Securities and Exchange Commission, and disclose any conflicts of interest in their recommendations.

[14] For more insight on the securities related activities of banks, see: U.S. Library of Congress. Congressional Research Service. *Profits of Banks and Securities Firms: Looking for the Greenest Grass*. Report No. 92-762 E, by Kevin Winch and Mark Jickling. Washington, 1992. 42 p. and *Glass-Steagall Act: Should Bankers Be Brokers*. Archived Issue Brief No. IB 91038, by William Jackson.

[15] Winch and Jickling, *Profits of Banks and Securities Firms: Looking for the Greenest Grass*, p. 4.

[16] Mack, *Recent Trends in the Mutual Fund Industry*. p. 1011. See footnote 8 for an explanation of the role of the various parties.

[17] Orders Approving Acquisition of a Bank Holding Company, Formation of a Bank Holding Company, and Application to Engage in Nonbanking Activities. *Federal Reserve Bulletin*, June 1993. p. 626-632 Administrative duties include: maintaining and preserving fund records; computing net asset value, dividends, fund performance data other fund financial information; furnishing statistical and research data; preparing and filing with the SEC and State securities regulators registration statements; preparing reports and other informational material pertaining to the fund, including proxies and shareholder information; providing office facilities and clerical staff for the fund; developing and implementing procedures for monitoring compliance with regulatory requirements and the fund's investment objectives; reviewing and arranging for payment of fund expenses; providing communication and coordination services with regard to the fund's investment advisor, transfer agent, custodian and other service providers; reviewing and providing advise to the distributor, the fund, and the investment adviser concerning the regulatory compliance of sales literature and marketing plans providing information to the distributor's personnel regarding fund performance and administration; assisting extant funds in the development of additional portfolios; and providing reports to the fund's board of directors with respect to their current activities.

[18] See: Robinson, Kenneth and Eric Ochel. Banks and Mutual Funds: Implications for Banking and Monetary Policy *Federal Reserve Bank of Dallas Financial Industry Studies*, December 1993. p. 2; and English, William and Brian Reid. Profits and Balance Sheet Developments at U.S. Commercial Banks in 1993 *Federal Reserve Bulletin*, June 1994 p 484-485.

[19] Ibid.

[20] Banks have traditionally undertaken many of the services that are also involved in the operation of mutual funds through their trust departments, which provide fee-based fiduciary, investment, custodial and managerial services to bank customers.

[21] For example, see: Kaufman, George and Larry Mote. Is Banking a Declining Industry. *Federal Reserve Bank of Chicago Economic Perspectives*, May-June 1994. p. 12

[22] Section 20 of the Glass-Steagall Act provides that affiliates of national banks and State chartered member banks may underwrite and deal in *ineligible* securities generally prohibited in the Glass-Steagall Act (such as mutual funds, municipal revenue bonds, and corporate debt and equity) so as long as the underwriting affiliate is not "principally engaged" (interpreted by the Federal Reserve Board to mean no more than 10 percent of the affiliate's revenues shall be derived from the underwriting). But, while the Fed has sanctioned a disparate collection of *ineligible security* underwriting activities for Section 20 affiliates, mutual funds have not been included.

[23] The Securities Industry Association, a trade group of securities firms, reports that over the last decade revenues from selling mutual funds to investors has grown tenfold. See: Laderman and Smith, *The Power of Mutual Funds*, p. 68. There are reports that in 1992, the average mutual fund family saw quite healthy net profits of between 25 and 30 percent of sales. See: Lappen, Alyssa. Fund Follies. *Institutional Investor*, October 1993. p. 42.

[24] For example, at the 1993 meeting of the American Bankers Association, a survey revealed that of the banks which reported they were losing general market share, 65 percent reported that they were losing business to mutual funds. Lipin, Steven. U.S Warns Banks on Failure to Comply with Guidelines on Selling Mutuals. *Wall Street Journal*, November 8, 1993. p. A16.

[25] For example, see bank consultant Edward Furash's comments in: Debra, Cope. On the Beat. *American Banker*, December 13, 1993. p. 16.

[26] For example, see. Zimmermann, Kim. Putting A Label on Mutual Funds. *United States Banker*, July 1991. p. 54, 56.

[27] For example, at the 1993 American Bankers Association convention, 44 percent of banks surveyed said that selling mutual funds and insurance are high priorities. Lipin, *U.S. Warns*, p. A-16.

[28] Klinger, Douglas. A Banker's Guide to Mutual Funds. *Bankers Monthly*, December 1992. p. 19-20.

[29] Senior Financial Officers' Survey on Retail Mutual Funds. Federal Reserve Board of Governors. May 1993. p. 3.

[30] Meenan, Peter Are Mutuals Funds in Your Future? *ABA Banking Journal*, April 1990. p. 51. Banks face competing pressures to retain depository accounts because of the wide spreads that presently exist between the interest that they charge on loans and the interest that they pay on depository accounts.

[31] Wayne, Leslie. Investments Soar in Mutual Funds, Causing Concerns. *Wall Street Journal*, September 7, 1993. p. A1.

[32] Lappen, Alyssa. Fund Follies. *Institutional Investor*, October 1993. p. 40. In addition, the Federal Reserve's Survey of Consumer Finance reports that, in 1989, U.S. households held 37 percent of their financial assets in the form of bank deposits and money market funds. By the end of 1992, this percentage had dropped to 31 percent. During the same period, the proportion of financial assets invested in long-term mutual funds grew from 10 percent to 13 percent. See: Mack, *Recent Trends in the Mutual Fund Industry*. p. 1008. By spring 1994, with the Fed nudging up short-term interest rates, the outflow of bank CD deposits appeared to have slowed. Jason, Georgette. Many Investors are Still Leery About Putting Money Into CDs. *Wall Street Journal*, April 19, 1994. p. 1.

[33] Rose, Sanford. Meeting the Challenge of Mutual Funds. *Journal of Retail Banking*, Fall 1993. p. 10.

[34] Lunt, Penny. How are Mutual Funds Changing Banks? *ABA Banking Journal*, June 1993. p. 31.

[35] By the end of 1993, the bank organizations with the 10 largest proprietary funds were: 1) PNC (Pittsburgh) with $20.7 billion; 2) NationsBank (Charlotte, North Carolina) with $13.7 billion; 3) BankAmerica (San Francisco) with $12.9 billion; 4) Wells Fargo (San Francisco) with $8.1 billion; 5) BankOne (Columbus, Ohio) with $7.4 billion; 6) Northern Trust (Chicago) with $6.9 billion; 7) NBD (Detroit) with $5.75 billion; 8) State Street (Boston) with $5.1 billion; 9) Chase Manhattan (New York City) with $5.0 billion; and 10) Norwest (Minneapolis) with $4.7 billion. Kantrow, Yvetta. Bank-Managed Funds Grew by 34 Percent in 1993. *American Banker*, February 9, 1994. p. 14.

[36] Cerulli Associates, *The State of the Bank Securities Industry*. Boston, 1993. p. 28.

[37] See: Lappen, *Fund Follies*, p. 43. Because Glass-Steagall does not permit banks to distribute the funds, they hire distributors to do so. Depending on the extent to which banks want to integrate permissible ancillary fund functions into their own operations, the distributor will be contracted to perform a varying range of those ancillary roles, including that of transfer agent, custodian, marketing, auditing and accounting, and shareholder services. Alternatively, banks may hire distributors to perform purely distribution oriented roles, while contracting with other firms to perform some or all of the ancillary services.

[38] Ibid.

[39] Mutual fund shares that are sold through brokers, financial planners operating on commission or sales forces, tend to include a sales charge in their offering price. Depending on the fund, this "front-end load" or simply "load" can be as high as 8.5 percent of the initial investment. This charge is in addition to a general management fee which usually runs between 0.5 and 1.0 percent of a fund's assets. In conjunction with or in place of the sales load, some funds assign a fee based on a percentage of fund assets to underwrite the fund's distribution expenses, including advertising, distribution of fund literature (such as prospectuses and annual reports), and funding the brokers who distribute the funds. These charges are called 12b-1 fees and can range between 0.25 percent and 1.25 percent, and are deducted from a fund's assets. Contingent sales or back-end loads are paid to selling organizations or salespersons and can be as high as 5 to 6 percent for shareholders who redeem their shares in the first year, declining by 1 percent per year for the first five or six years. Some fund management companies charge exit fees to cash out of a fund or to switch from one fund under their management to another fund under their management.

[40] See: Hinden, Stan. Some Wrongs that Become Rites. *Washington Post*, November 17, 1993. p. G3, and Lappan, Alyssa, *Fund Follies*. p 43 CRS has also come across one rather extreme estimate that stock mutual funds may require a minimum size of $500 million in assets to be profitable. The figure adds to the general impression that estimating general break-even sizes for mutual funds is far more of an (imprecise) art than a science.

[41] Cerulli Associates, *The State of the Securities Industry*, p. 19-40.

[42] This relative youthfulness may be the underlying cause of scattered criticism that some banks are plunging into proprietary funds with inadequate investment management expertise, a shortfall which could be particularly problematic in the event of a major market downturn. In fact, recently, the SEC sanctioned a commercial bank for mispricing a money market fund that it managed. The regulatory agency observed that the bank failed to recognize a sharp decline in the value of the fund's bonds and criticized the bank's internal controls for failing to detect and address any wrongdoing Szudlo, Raymond. Mutual Funds: Opportunities and Risks. *Bankers Magazine*, March/April 1994. p. 26.

[43] How banks respond to their unprofitable proprietary funds, however, may vary Some commentary suggests that banks may not have the patience to wait 5 to 10 years (as many non-bank funds have reportedly been able to do) for their funds to evolve and grow and perhaps achieve some profitability The idea here is that banks operate under comparatively short-term financial pressures, and are not inclined to a "patient capital" mindset. However, other commentary suggests that many banks have developed proprietary funds not chiefly for profit considerations, but essentially as a means of holding onto their customer base of depository accounts who may seek the potentially higher returns offered by mutual funds

[44] Lappan, *Fund Follies*, p. 43.

[45] Hinden, *Some Wrongs that Became Rites*, p. G3. Individual funds within a fund group may be profitable or unprofitable. A fund group is profitable if its funds collectively have revenues in excess of direct and indirect operational costs. With respect to individually profitable proprietary funds, some commentators have observed a general hierarchy of profitability that is largely a function of fund type. For example, Sanford Rose estimates that. 1) profitable proprietary money market funds generally achieve spreads (difference between total costs and revenues) of 2 to 5 basis points; profitable proprietary funds generally have spreads of around 23 basis points; and profitable fixed income (bond) funds come in at spreads of around 20 basis points. See: Rose, *Meeting the Challenge of Mutual Funds*, p. 10. (A basis point is one-hundredth of a percentage point.)

[46] Cerulli Associates, *The State of the Bank Securities Industry*, p 28.

[47] For example, Diane Goldman, a bank stock analyst at Salomon Brothers, has commented:

> There were some pretty unreasonable expectations on the part of some bankers about how quickly they would be able to take the mutual fund business by storm. (Wooley, Susan with Kelley Holland and Nanetta Byrnes *Business Week*, September 5, 1994. p. 74.)

[48] This situation has reportedly led to a number of banks placing limits on the number of non-proprietary funds that can be sold.

[49] Between 1970 and 1992, the average front-end load fell from 8.5 percent to 4.5 percent. See: Mack, *Recent Trends in the Mutual Fund Industry*, p 1007.

[50] For example, see: Steinmetz, Greg and Sara Calian. Fund's Company Size is Seen as Essential to Survival. *Wall Street Journal*, May 26, 1994. p. C1. While the number of mutual funds has steadily proliferated over the last several years, the demand for various investor amenities has also soared. These "amenities" include daily account reporting, daily fund valuation information by phone, technology which allows at-will transfers among the funds in a family, and remote customer services. These amenities contribute nontrivial costs to fund operational costs and add to fund pressures to raise prices at a time when the growing number of funds exerts downward pressure on pricing.

[51] For example, James McCormick, President of First Manhattan Consulting Group, prognosticates:

> . . Over time banks will own the majority of the mutual fund and regional brokerage business, and this [Mellon-Dreyfus] will be viewed as one of the first major steps in that evolution. (Rehm, Barbara and Debra Cope. Comptroller Blesses Mellon-Dreyfus Deal. *American Banker*, May 5, 1994. p. 1.)

This view is corroborated by SEC Chairman Arthur Levitt who has called the merger a precursor of future bank/mutual fund marriages. Still, other observers point out that virtually all of the top mutual fund families are privately held and have largely shown no interest in mergers. For example, recently, new reports followed the abortive "hostile takeover" attempt of Kemper Funds by General Electric.

[52] See: SEC News Release 93-55. November 10, 1993 These misperceptions are not at all confined to bank-marketed mutual funds; the same survey noted that 36 percent of the households thought that mutual funds which are marketed by stockbrokers were also insured

[53] Should You buy Mutual Funds from Your Bank? *Consumer Reports*, March 1994. p. 148-150.

[54] Ibid., p. 148.

[55] Ibid. In February 1994, the General Accounting Office (GAO) embarked on an ambitious survey of 3,400 banks and savings and loans institutions. The GAO questionnaire will ask the financial institutions about such issues as: whether they show preferential treatment for their sales of proprietary funds over third-party funds; the types of bank personnel who are allowed to talk to customers about investment products; and what customer disclosures are being provided about investment products. GAO officials expect the results of the survey to be available in the fall of 1994 (See: Talley, Karen. Congress' Watchdog Agency Studying Fund Sales at Banks. *American Banker*, March 1, 1994. p. 1.)

[56] For an overview of bank regulators and their jurisdictional concerns, see: U.S. Library of Congress. Congressional Research Service. *Commercial Banking: An Analytical of its Regulation and Structure*. Report No. 92-721 E, by F. Jean Wells, William Jackson and M. Maureen Murphy. Washington, 1992. 17 p. In a recent survey of mutual fund investor, the Investment Company Institute (ICI), the mutual fund trade association, found that people who had purchased at least one fund from a bank were more likely not to be college educated and more likely to be a woman than is the average mutual fund investor. However, the average bank fund buyers had higher average incomes that did the average mutual fund buyer

[57] See: OCC Banking Circular No. 274 (July 19, 1993); letter from Richard Spillenkothen, Director, Federal Reserve Division of Banking Supervision and Regulation on "Separation of Mutual Fund Sales Activities from Insured Deposit Taking Activities" (June 17, 1993); FDIC Supervisory Statement on State Nonmember Bank Sales of Mutual Funds and Annuities (October 8, 1993); and OTS Bulletin 23-1, "Guidance on the Sale of Uninsured Products" (September 7, 1993).

[58] For example, the Fed's guidelines asked banks to prohibit employees who assist customers to open insured deposit accounts from any involvement in the sale of mutual funds. The OCC's guideline allowed such employees to sell mutual funds if they have received proper training to sell the funds and if their dual role (with respect to the bank's insured products and its mutual funds) is made clear. While the Fed advised banks to physically separate the marketing of insured deposit accounts and mutual funds, the OCC only asked that banks "take steps to separate the two activities."

[59] Interagency Statement on Retail Sales of Nondeposit Investment Products. February 15, 1994.

[60] The National Association of Securities Dealers (NASD) is a nonstock membership organization formed under the Securities Act of 1934 to act as primary regulator of securities sold in the over-the-counter market. A self-regulatory organization (SRO), NASD has members that include securities broker-dealer and underwriters other than commercial banks. NASD governs its members in trading policies and procedures, listing of new issues and customer relations, and it also licenses broker-dealers.

[61] Cope, Debra Some Banks Fail to Make Fund Risks Clear. *American Banker*, March 1, 1994. p. 11.

[62] Prakash, Snigdha. Other Regulators Still Balking at OCC "Mystery Shopper" Program. *American Banker*, June 10, 1994 p 10.

[63] For example, see the testimony of: John LaWare, Governor, Board of Governors, Federal Reserve Board System (page 103); Eugene Ludwig, Comptroller of the Currency (page 127) ; and R. Scott Jones, representing the American Bankers Association (page 29) from: U.S. Congress. House. Subcommittee on Financial Institutions Supervision, Regulation and Deposit Insurance of the Committee Banking, Finance and Urban Affairs. *Bank Sales of Mutual Funds*. Hearing, March 8, 1994 103rd Congress, 2nd Session. Washington, G.P.O., 1994 (Hereinafter called the Bank Sales Hearing)

[64] U.S. Congress. House. Subcommittee on Oversight and Investigations of the Committee on Committee on Energy and Commerce. *Proposed Mellon-Dreyfus Merger*. Hearing, March 2 and 3 1994 103rd Congress, 2nd session. Washington, G.P.O., 1994. p. 406. (Hereinafter called Mellon-Dreyfus Hearing)

[65] March 1, 1994 memorandum from the Hon. John Dingell to Members, Subcommittee on Oversight and Investigation. Mellon-Dreyfus Hearing p. 405.

[66] OCC Weighing New Regulatory Options in Response to Surging Sales of Funds. *Daily Executive Report*, March 4, 1994. p A-24. The germane language in the guidelines that relate to the issue of enforceability is ". . . Failure of a depository institution to establish and observe appropriate policies and procedures consistent with this Statement in connection with sales activities involving nondeposit investment products *will be subject to criticism and appropriate regulatory action*."

[67] Ibid

[68] House Banking Subcommittee Considers Need for Legislation on Bank Fund Sales. *Daily Report for Executives*, March 3, 1994. p. A-18.

[69] Ibid.

[70] OCC Reaches Agreement with NASD on Testing Bank Employees, Ludwig Says. *Daily Report for Executives*, September 28, 1994. p. A-19.

[71] Statement of Chris Lewis, director of Banking and Housing Policy for the Consumer Federation of America in the Mellon-Dreyfus Hearing. p. 71.

[72] Op cit. (page 255):

> So what happens to an elderly consumer when she walks in to the bank seeking a safe place for the $50,000 she has just earned in the sale of her house? Does the teller -- with the thoughts of a referral fee at hand -- urge her to forego government insurance and, instead invest in some of those nice securities being sold at the desk across the lobby?

[73] American Bankers Association, et al. *Retail Investment Soles -- Guidelines for Banks* February 1994 p v.

[74] Ibid.

[75] Talley, Karen. NASD to Provide Guidelines For Banks' Mutual Fund Sales. *American Banker*, June 10, 1994 p 16

[76] Remarks of Congressman Charles B. Schumer. Bank Sales Hearing. p. 78-79.

[77] Ibid., p. 80–81

[78] Testimony of R. Jones Scott on Behalf of the American Bankers Association at the Bank Sales Hearing. p. 22-23

[79] Testimony of Jonathan Fiechter, Acting Director, Office of Thrift Supervision in Bank Sales Hearing. p. 143-145.

[80] Testimony of Jonathan Fiechter, Acting Director, Office of Thrift Supervision in the Bank Sales Hearing. p. 144

[81] Testimony of Philip Feign, Securities Commissioner of Colorado and President Elect of NASAA. Bank Sales Hearing. p. 9.

[82] FDIC Acting Chairman, Andrew Hove, Jr. stated.

> The FDIC has resisted developing detailed regulations of this type [H.R. 3306] up to this point because of the broad and varied nature of the products to be covered, the fact that bank programs are new and evolving, and our desire to allow the private sector to develop product lines and programs desired by bank customers so long as certain important principles, such as safe and sound operations and avoidance of potential customer confusion, are assured. . . Bank Sales Hearing (p. 14)

[83] Ibid., p. 15.

[84] Statement of R. Scott Jones on behalf of the American Bankers Association Bank Sales Hearing p. 24-26.

[85] Ibid.

[86] Cope, Debra. With Rules in Flux, Banks are Wary on Names for Funds. *American Banker*, November 8, 1994. p. 29.

[87] The role played by regulatory inadequacies in the savings and loan problems of the 1980s has received varying interpretations. For example in: Pizzo, Stephen with Mary Fricker and Paul Moulo. *Inside Job*, New York, Harper Perennial. 1991, the authors observe that the legislative deregulation of the industry helped foster an environment in which many savings and loan officials were guilty of either stretching the law or committing outright fraud significantly contributing to the billions of dollars in losses for the industry. The authors contend that significantly abetting the many violations was a lax and unresponsive attitude on the part of the industry's regulators (p. 28-29). However, another book (Pierce, James. *The Future of Banking*, New Haven, Twentieth Century Fund, 1991) takes a somewhat more sympathetic view of the regulators. The book acknowledges the critical role played by regulatory ineptitude and laxity in the thrift crises, but also observes that the legislative deregulation of the industry in the early 1980s made thrifts into far more complex institutions — both in the financial products offered to consumers and the types of investments that they could make. These institutional complexities were said to be so daunting that both quantitatively and qualitatively they overwhelmed the thrift regulators, largely weaned in an era of far less complex savings and loans

[88] Dingell, John. Securities Regulation Equality Act of 1993. *Congressional Record*, November 10, 1993. p. E2845-E2846. Note: Chairman Dingell has signed on as a co-sponsor of H.R. 3306. However he has given conditional support for it and views the legislation as a secondarily important complement to H.R. 3447 since he sees functional regulation of bank securities activities as a far more critical need

[89] Testimony of Arthur Levitt, Chairman of the SEC. Mellon-Dreyfus Hearing. 1994 p. 5.

[90] Ibid.

[91] Bank Regulators Defend Mutual Fund Sales Oversight to House Subcommittee. *Daily Report for Executives*, April 15, 1994. p. A-29.

[92] Ibid.

[93] Ludwig Says Bank Regulators, Not SEC Should Oversee Bank-Sold Funds. *Daily Report for Executives*, June 7, 1994. p. A-9.

[94] Testimony of John LaWare, Governor of the Federal Reserve System. Testimony in: U.S. Congress House Subcommittee on Telecommunications and Finance of the Committee on Energy and Commerce. *Securities Regulatory Equality*. Hearing on H.R. 3447. April 14, 1994. Washington, G.P.O., 1994 p. 172-173. (Hereinafter called the Hearings on H.R. 3447.)

[95] This is identified as 12 USC 1818.

[96] OCC Weighing New Regulatory Options in Response to Surging Sales of Funds. *Daily Report for Executives*, March 4, 1994. p. A-24.

[97] In a break with the general opposition to H.R. 3447 on the part of the banking industry, officials at the money center bank, the Mellon Bank Corporation (which merged with the large mutual fund family, Dreyfus) testified in favor of functional regulation. U.S. Congress House. Hearing on H.R. 3447, p. 143.

[98] Bank Regulators Defend Mutual Fund Sales to Oversight House Securities Committee. *Daily Report for Executives*, April 15, 1994. p. A-29-A-30.

[99] Ibid. In response to questions about exempting small banks from H.R. 3447, Governor LaWare suggested that it might make sense to exempt banks with less than $500 million in assets.

[100] Talley, Karen. House, Senate Wrestle Over Fund Regulation. *American Banker*, November 16, 1993. p. 12.

[101] Ibid.

[102] Ibid.

[103] Testimony of Arthur Levitt. Hearing on Mellon-Dreyfus. p. 17-19.

[104] Ibid.

[105] Oral Statement of Mathew P. Fink, President of the Investment Company Institute. Hearing on H.R. 3447. p. 235.

[106] The aggressiveness of SEC enforcement during the 1980s in cases such as Drexel Burnham Lambert may have been less a function of an entrenched institutional "sggressiveness" at the agency and more a function of the personality of Gary Lynch, head of the SEC's enforcement division during that time. In fact, the enforcement division under Mr. Lynch is described as aggressively going after Drexel Burnham Lambert despite SEC Chairman John Shad's "beneficent view" of the company and its principal, Michael Miliken. This perspective comes from a well-received treatment of the relationship between the SEC and Wall Street in the 1980s: Vise, David and Steve Coll. *Eagle on the Street*. New York, Collier Books, 1991. p. 360–362.

[107] These include: (1) loans to insiders that exceed allowable loan limits; (2) loans to insiders with preferential terms; (3) failure to maintain required records; (4) failure to obtain required bank board approval for loans; and (5) overdraft payments exceeding allowable limits.

[108] U.S. General Accounting Office. *Bank Insider Activities: Insider problems and Violations Indicate Broader Management Deficiencies*. Washington, GPO, 1994. p. 47–48. Cited in Oral tatement of Mathew P. Fink. Hearing on H.R. 3447. p. 236.

[109] For example, see: Oral Statement of Mathew Fink. Hearing on H.R. 3447. p. 239. Comptroller Ludwig has acknowledged that institutional regulation with its multiple bank regulators can lead to the promulgation of inconsistent standards for the same kinds of investment products. However, he contends that this is a problem that can be worked out. *Ludwig Says*, p. A-9.

[110] Ibid. For a discussion of the initiatives to consolidate the bank regulators, see: U.S. Library of Congress. Congressional Research Service. *Bank Regulatory Agency Consolidation Proposals: A Structural Analysis*; An Issue Overview. Report No. 94-256 E, by F. Jean Wells and William Jackson. Washington, 1994. 6 p.

[111] October 1994 conversations between CRS and SEC officials.

[112] Financial Support Provided to Proprietary Funds by Bank Holding Companies. *Board of Governors of the Federal Reserve System Staff Paper*, October 17, 1994. p. 1-6.

[113] For example, see: Greenspan Says Seven BHCs Propped Up Mutual Fund Due to Structured Notes. Daily Report for Executives, October 21, 1994. p. A-13.

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STANLEY T. RADGE
OF COUNSEL

I'm in town for tomorrow's hearing and can be contacted through Sunday at (202) 293-2100. I'd be happy to respond to any questions you might have or to meet with you.

Re: Hearing by the Senate Committee on Aging

We are representing both bank customers and bank brokers. The Senate Committee is examining a crisis in which thousands of banking customers have been mislead and injured by the banking institutions with which they have entrusted their life savings.

Banks have recently been permitted to manage mutual funds, and to sell shares of these mutual funds to their bank customers, on the bank premises. For banks, this new market presents a potentially huge source of profits -- the management fees they receive for operating the mutual funds are directly related to the asset size of the fund -- the more money in the fund, the higher the bank's management fee. Also, the banks have established securities divisions to sell the mutual fund shares to their customers, and receive large commissions for doing so. Unfortunately, these banks target all their sales efforts at one audience - their customers, and in their zeal to enter this market, some banks are using sales tactics which are harming their banking customers.

Bank customers -- particularly those who remained in low-yielding CD's during the interest rate slump, are ultra-conservative and extraordinarily risk averse. The banks employ a variety of tactics designed to confuse the bank customer as to the real nature of the new products offered, and mislead them into believing the new products are guaranteed or insured. For example:

(1) advertisements for the securities products are strewn liberally throughout the deposit area of the bank, alongside information on traditional bank insured products;

(2) persons who are obviously bank employees advise the bank customers to consult with an "investment officer" of the bank regarding alternatives to low-yielding bank CD's;

(3) The investment officer is indistinguishable from any bank employee, and indeed, conducts all his business from the same location used to conduct traditional bank business.

The banks also use solicitation techniques designed to confuse their customers. For example, the bank often provides confidential information, such as the dollar value of bank accounts and the dates of CD maturities, to the securities sales force. The bank customer then receives a phone call or letter regarding his maturing CD or his sizable bank balance, advising him to contact a bank investment officer to discuss more profitable uses of his money. In another frequently-used tactic, bank employees, such as branch managers, telephone or write the bank customer and advise him to contact the investment officer regarding alternatives to CD's. The customer's automatic association with the bank is thus reinforced.

To aggravate the customer's confusion, the bank's securities division and the securities products offered often have names which are very similar to the name of the bank. Some banks thus do everything they can to create and exploit the customer's association of the securities salesmen and the securities products with the bank. The banks and the securities sales force know that, and encourage, the bank customers to associate <u>anything</u> offered by the bank with safety, conservatism, and FDIC insurance. In this atmosphere of confusion, the bank customers are solicited to purchase securities. These securities are presented as reasonable alternatives to CD's, but offering higher rates of return than the bank otherwise paid.

Unfortunately, the customer often receives an inadequate explanation of the tremendous distinctions between traditional bank-guaranteed or FDIC-insured products, and the market-sensitive securities. The securities expose the customer to many fees and risks not associated with traditional bank products. For example:

(1) In a mutual fund the principal investment is in no way guaranteed, assured, or safeguarded by the bank or the government, but rather, is sensitive to changing market conditions beyond the control of the bank or the customer, and could easily fall in value;

(2) Despite the fact that the customer purchases the security at the same location he previously made savings account deposits, or purchased CD's, the security is not insured by the FDIC or guaranteed by the bank;

(3) An affiliate of the bank receives a percentage of the value of the mutual fund as payment for managing the fund, and this payment is made regardless of the fund's performance;

(4) The mutual fund securities involve large selling commissions, often as high as 6%, and this amount comes directly from the customer's investment principal;

(5) Regardless of the performance of the mutual fund, the customer can often not sell his shares without incurring a substantial loss, or be subjected to deferred sales charges;

(6) The bank employee who referred the customer may receive a generous commission or bonus when the customer buys the mutual fund shares; and

(7) Once the customer purchases the securities, the bank and its securities division do everything possible to lull the customer's continuing belief that what he purchased is in fact related to the bank. Thus, for instance, confirmation slips and account statements do not clearly advise the customer that his investment is not insured or guaranteed by the bank. Also, the bank often arranges paperless transfers of money to purchase dividends, and even withdrawals from the securities account.

Customers do not realize the injury they have suffered until their account statements reveal that their principal investment could, and in fact does, fluctuate in value. Bank customers whose primary concern is safety of principal are unprepared to witness any change in its value. However, when they complain to the bank or the bank's securities division, they often find for the first time that if they sell the mutual fund shares, they would automatically incur a large deferred sales charge and or large loss.

Compounding these problems is the fact that the banks have largely been allowed, by the various banking and securities regulators, to police themselves in their sales of securities. Historically, neither the OCC, the Federal Reserve Board, nor the SEC have subjected the bank's securities activities to any meaningful scrutiny. Unfortunately, customers' complaints to the bank and the brokerage division go unheeded, as the bank often sends a standard response to its customers that, in the brokerage's opinion, the customer has been fully advised as to the nature of his investment. The fact that so many bank customers have been astonished to learn that their principal is at risk, however, is clear evidence that in fact, the customers are not fully advised of the nature of the investment. The attention of the Senate Committee has now been focused on this injury.

RETAIL INVESTMENT SALES

Guidelines for Banks

A Joint Project of:

American Bankers Association
•
The Bankers Roundtable
•
Consumer Bankers Association
•
Independent Bankers Association of America
•
National Bankers Association
•
Savings & Community Bankers of America

FEBRUARY 1994

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EXECUTIVE SUMMARY

Working together, the nation's six banking trade associations have prepared voluntary guidelines for bank retail sales of mutual funds and other nondeposit investment products. The guidelines are intended to complement the four separate sets of guidelines and policies issued by the bank regulators in 1993.

The guidelines explain how to put many of the regulators' recommendations into action. They address the appropriate setting and circumstances for bank sales of nondeposit investment products and suggest proper disclosure policies for communicating the uninsured nature of these products to customers, the extent to which certain employees may become involved in such transactions, acceptable employee qualifications and training, and a number of other important considerations.

The Purpose

By drafting guidelines in this area, the six trade associations intend to accomplish four primary results:

1. Enhance Customer Protection

These guidelines demonstrate the banking industry's commitment to making its customers aware that mutual funds are not FDIC-insured. They place a strong emphasis on oral and written disclosure and on ways to help customers understand the uninsured nature of investment products.

2. Complement Regulatory Policy

These guidelines complement the four separate policies adopted by the regulators. The regulators' policies are not identical; one set of guidelines that will cover all banks and thrifts would be helpful.

3. Help Banks Comply

These guidelines can assist banks in complying with their regulators' requirements. For example, banks need to develop internal policies and procedures regarding bank retail sales of nondeposit products. The industry guidelines are designed to help banks do that by raising issues that must be considered.

4. Encourage Training and Qualifications

The industry guidelines suggest appropriate training and qualifications for bank sales personnel. Training and qualifications should be incorporated into bank policies and procedures.

Summary

Oral and Written Disclosure

Customers should be informed both orally and in writing at the time of account opening or initial purchase of a nondeposit investment product that such products—

- are not bank deposits,
- are not obligations of, or guaranteed by, any bank,
- are not insured or guaranteed by the Federal Deposit Insurance Corporation or any other government agency, and
- involve investment risk, including the possible loss of principal.

Signed Disclosure

The regulators have stressed the importance of keeping customers fully informed of the nature of nondeposit investment products. The industry's guidelines provide a sample form acknowledging that the customer has read and understands the written disclosures.

Advertising and Promotion

All advertising and promotional, marketing, and sales materials should contain conspicuous and prominent notice of the uninsured nature of such investment products. In order to be conspicuous and prominent, the disclosures should be appropriately placed and in appropriate style and size of type so that the disclosures will not escape the customer's attention. For example, disclosures are not conspicuous and prominent if they are lost in the middle of a multi-page document or if they are in typeface that is too small relative to the other typefaces used in the document.

Location

Sales of nondeposit investment products that occur in a bank should, to the extent permitted by space and personnel considerations, take place in areas that are physically separate and/or distinct from routine deposit-taking activities. Signs and/or some other means may be used to distinguish any investment sales area from the areas where routine retail deposit-taking functions occur.

Setting and Circumstances

Employees acting as tellers should be prohibited from selling nondeposit investment products and from offering investment advice regarding such products. Tellers may refer customers to the appropriate location and/or individual in the bank and may respond to customer questions regarding general procedures for purchasing nondeposit investment products from the Designated Sales Representative ("DSR").

Nondeposit investment products should be sold only by qualified personnel (for example, properly trained bank employees, registered representatives, or licensed annuities salespersons). Investment advice should be given only by qualified, and if required, licensed personnel.

Employee Qualifications and Training

Bank management, DSRs, and audit and compliance personnel involved with the bank's investment product program should demonstrate competence appropriate to the function or responsibilities assigned to them by the bank's retail investment policies and procedures.

When appropriate and possible, DSRs should obtain an appropriate NASD license, such as a Series 6 or 7. A NASD license equivalency certificate may also be appropriate. Furthermore, the guidelines state that background checks for all new DSRs who will be engaged in the offering and/or sale of nondeposit investment products are strongly recommended. Reviews of new employees with previous securities or insurance industry experience should include a check with appropriate authorities for prior disciplinary actions.

Industry trade groups should assist their members in obtaining appropriate training in the sale of nondeposit investment products.

Employee Compensation and Referral Fees

Suitability, not compensation, should guide sales of nondeposit investment products. Compensation for the sale of nondeposit investment products should be structured to avoid incenting the sale of unsuitable products. DSRs should be free to offer customers a choice of investment products that provide different levels and types of compensation. However, sales personnel should not favor or disfavor the sale of a particular investment company, group of investment companies, or insurance company product based solely on receipt of brokerage commissions or other incentives.

Compensation to tellers and other bank employees for referrals is permissible but should not be based on the success of the referral in generating a sale of a nondeposit investment product.

Bank Management and Board of Directors Oversight

A bank should establish and maintain written policies and procedures regarding retail sales of nondeposit investment products. Such policies and procedures should encompass third-party and affiliated vendor sales, sales of proprietary products, and sales of both third-party and proprietary products by bank personnel, as applicable.

Bank management should establish, maintain, and enforce a system to manage its retail investment activities and those DSRs involved with offering nondeposit investment products to the retail public. Such a system should be reasonably designed to achieve compliance with applicable banking, securities, and insurance laws and regulations. Final responsibility for proper oversight should rest with bank management.

A compliance program, independent of investment product sales and management, should be established. The program should be capable of verifying compliance with applicable laws.

SCOPE OF COVERAGE

These guidelines apply to domestic retail sales of nondeposit investment products (including marketing and promotional activities) to individuals by or through any FDIC-insured depository.

FDIC-Insured Depository

This term includes FDIC-insured commercial banks, savings banks, and savings associations (hereafter referred to collectively as "bank"). Thus, these guidelines cover retail sales (including marketing and promotional activities) by employees of such banks, whether made on or off the premises of the depository. This also includes retail sales (including marketing and promotional activities) conducted by employees of the bank by telephone, through the mail, or at the residence or place of business of the prospective customer.

Bank-Related Sales

These guidelines apply to domestic retail sales (including marketing and promotional activities) by employees of corporate entities related to the bank. Related corporate entities include affiliates as defined in the Bank Holding Company and Savings and Loan Holding Company Acts. Related corporate entities also include companies that pay to the bank or its employees a direct monetary benefit or other compensation for the purpose of selling nondeposit investment products to bank customers. For example, third-party networking arrangements are included in this category. The guidelines govern retail sales by all such entities and their employees where the sale occurs on the premises (bank floor/lobby) of the bank, results from a telephone call or written communication initiated from the premises of the bank, or results from a solicitation of bank retail deposit customers.

On the other hand, these guidelines do not apply to retail sales conducted through bank affiliates where the sale does not occur on or through bank premises or otherwise has not resulted from solicitations directed to retail deposit customers of the bank. These guidelines are intended to work in tandem with the rules of the Securities and Exchange Commission ("SEC") and the National Association of Securities Dealers, Inc. ("NASD"), to the extent those rules are applicable. Special attention should be given to *NASD Notice to Members 93-87, December 1993.*

Designated Sales Representative

Designated Sales Representatives ("DSRs") are personnel who are authorized and qualified to sell nondeposit investment products. As such, a DSR can be a properly trained bank employee, a registered representative, or a licensed annuities salesperson.

Nondeposit Investment Products

These guidelines apply to the retail sale, promotion, and marketing of: mutual funds, annuities, commercial paper, securities (including bank and bank-affiliated securities), and all other investment products not insured by the Federal Deposit Insurance Corporation ("FDIC"). These guidelines do not apply to United States savings bonds.

Retail Sales

These guidelines apply to sales to individuals. Such sales are defined as "retail sales" and include promotional and marketing activities that are aimed at either deposit customers or the general public. Excluded from the coverage of these guidelines are the following:

Sales to sophisticated customers. These guidelines do not apply to "sophisticated" customers. Such customers are defined to mean: institutional investors; individuals with a net worth or individuals who with their spouse have a joint net worth exceeding $1 million; and individuals with net income of $200,000 in each of the two most recent years or who with their spouse have joint income in excess of $300,000 in each of those years and who have a reasonable expectation of reaching the same income level in the current year.

Large denomination products. Sales of large denomination bankers' acceptances, commercial paper/master notes, repurchase agreements, variable rate demand notes, or other money market instruments, whether or not issued or guaranteed by the insured depository or its affiliates, are not covered by these guidelines. Such investments are recognized by the federal regulators as being sold to sophisticated investors, owing to their large minimum denominations, and are, consequently, not deemed to be "retail" in nature.

Fiduciary activities. Sales to fiduciary accounts (that is, where the bank exercises substantial investment discretion) are not covered by these guidelines but are covered by applicable fiduciary laws.

APPLICABLE LAW AND REGULATION

Bank retail sales of nondeposit investment products are regulated at both the federal and state levels under several different regulatory schemes. The following is an attempt to briefly outline applicable law and regulation. This outline is not a substitute for advice of counsel. Competent legal counsel should be consulted before embarking on any program offering nondeposit investment products to the retail market.

Securities

Retail sales of securities by national banks are subject to the rules and regulations of the Office of the Comptroller of the Currency ("OCC"). Retail sales of securities by state-chartered members of the Federal Reserve System or by insured state-chartered non-FED member banks are regulated by the Federal Reserve Board ("FED") or by the FDIC, respectively. Retail sales of securities by federally-chartered and insured state-chartered savings associations are regulated by the Office of Thrift Supervision ("OTS").

All banks and bank affiliates that engage in the retail sale of securities are subject to the antifraud provisions of the federal securities laws. For these purposes, the federal securities laws include the Securities Act of 1933, the Securities Exchange Act of 1934, the Investment Advisers Act of 1940, and the Investment Company Act of 1940.

Should a bank employ a third-party broker-dealer or even a bank-affiliated broker-dealer, the broker-dealer's activities would be subject to the jurisdiction of the SEC, as well as a securities self-regulatory organization such as the NASD or the New York Stock Exchange ("NYSE"). Thus, for example, retail sales of securities by third-party broker-dealers on the premises of a national bank could be subject to the rules and regulations of the OCC, the SEC, the NASD, and/or the NYSE.

Finally, and not to be overlooked, are state banking and securities laws. While the Federal Deposit Insurance Corporation Improvement Act of 1991 ("FDICIA") provides that, without prior FDIC approval, state-chartered banks could not engage as principal in activities prohibited to national banks, it is conceivable that state banking laws could prohibit state-chartered banks from engaging in certain activities permitted for national banks. In addition, state securities laws must also be consulted.

Annuities

Annuities are financial instruments that may also be deemed to be either an insurance product and/or a security product, depending upon the specific law applicable and the nature of the annuity contract. Generally, variable annuities are considered securities, and fixed-rate annuities may be considered either financial instruments or insurance products; however, legal counsel should be sought if there is any question in making this determination or in identifying applicable licensing requirements.

In this last regard, special care should be used when the bank involved is federally-chartered to ensure whether federal law, as applied by the appropriate federal regulatory agency, is consistent with or preempts state law. Again, consultation with legal counsel is recommended.

LOCATION OF SALES

To foster customer understanding that nondeposit investment products are not FDIC-insured, this and the following section on Setting and Circumstances are to be read together.

General

Sales of nondeposit investment products that occur in a bank should, to the extent permitted by space and personnel considerations, take place in areas that are physically separate and/or distinct from routine retail deposit-taking activities regardless of whether the sales are made by bank employees, an affiliated broker-dealer, or a third-party broker-dealer.

Signage

Any area designated as the investment sales location, including a new account area, should be clearly and prominently identified with signs and/or displays that distinguish this area from routine retail deposit-taking functions.

> For example, signs in the platform area could indicate "Investment Center" or list the name of the broker-dealer firm conducting investment sales. The investment sales area may be part of a lobby when such area is distinguished from the retail deposit-taking functions area in the same lobby. Walls, handrails, shelves, display units, plant arrangements, furniture and equipment, signage, or some other means may be used to distinguish the investment sales area from the retail deposit-taking functions area.
>
> Use of visual illustrations are acceptable means to identify an area where investment sales occur. For example, one bank has placed the FDIC logo in a circle that is slashed through to indicate the lack of such coverage. (*See* the next page.)

Comptroller Ludwig gave this example in the fall of 1993 of a format for "good disclosure" for mutual fund sales. Of course, banks may design their own format.

MUTUAL FUNDS AND ANNUITIES...

- **are NOT FDIC insured**
- **are NOT obligations of Anytown Bank**
- **are NOT guaranteed by the Bank**
- **involve investment risk, including possible loss of principal**

Key Element: Conspicuous Type

Key Element: Essential Information

Key Element: Clear Message

**Note: These disclosures do not conform precisely to those recommended in these guidelines.*

Written Policy

Written policies governing the sales of nondeposit investment products that occur or are initiated on bank premises should take into account in general terms the location(s) within the bank at which these transactions will occur.

Regulatory Designation of Location

Bankers should note that, if sales of nondeposit investment products are conducted by a registered broker-dealer, the area of the bank in which the sales occur may have to be registered with the NASD, depending on the type and extent of activities being conducted.

SETTING AND CIRCUMSTANCES

Tellers

Employees while acting as tellers should be prohibited from selling nondeposit investment products and from offering investment advice regarding such products.

Referrals

Tellers may refer customers to the appropriate location and/or individual in the bank for the sale of nondeposit investment products.

Inquiries

Tellers may respond to customer questions regarding general procedures for purchasing nondeposit investment products from the designated sales representative. Tellers are prohibited from discussing the merits of particular investment products.

> For example, tellers may say: "If you wish to discuss an investment, you may speak with Mr. or Ms. X, whose desk is located...."

Designated Sales Representatives

Nondeposit investment products should only be sold by qualified personnel (for example, properly trained bank employees, registered representatives, or licensed annuities salespersons). Investment advice should be given only by qualified, and if required, licensed personnel. DSRs who are bank employees may, in connection with exercising their suitability responsibilities (*see* Suitability section), sell customers an insured deposit product, as appropriate.

Bank Employees

Generally, bank employees may, where permitted by state law, perform ministerial and clerical functions related to investment product sales, including referring potential customers to the designated sales location or representative. They may assist prospective customers in completing account applications and forwarding paperwork to the DSR. Informational brochures or materials may be distributed to potential customers. Other examples of these clerical and ministerial functions include the following:

> Employees may assist customers interested in nondeposit investment products in completing a customer profile application that contains questions about customer income, investment goals, and existing account relationship(s) with the institution.
>
> Employees may complete profiles using a computer software program. Such programs may consider the customer's investment in insured products as well as nondeposit investment products.

Savings associations are cautioned, however, to review a recent SEC no-action letter on this issue. *INVEST Financial Corp., August 27, 1993.*

Identification of Personnel

Name Tags

If it is customary for bank personnel to wear name tags, the name tag of the DSR should also indicate the sales representative's title, such as "investment specialist," "investment counselor," or "investment representative."

Business Cards

Dual employees should have business cards, identifying them as bank employees and as employees of the broker-dealer, if applicable.

Customer Information

Customer information—such as name, address, telephone number, and types of products (including certificates of deposits) purchased—may be used by DSRs to determine potential prospects for nondeposit investment products. Other customer information may be used with appropriate notice and customer opportunity to object to disclosure of such information. Banks are cautioned to consult applicable state and federal requirements.

Product Name

A nondeposit investment product should not have a name that is identical to the bank's name (unless, of course, the securities of the bank, its affiliates, or its parent are being sold). Banks should take steps, such as enhanced training, to minimize possible customer confusion when a nondeposit investment product has a brand name similar to the bank's name or when the generic names of insured and uninsured products are similar (for example, money market mutual funds and money market deposit accounts). The relationship, if any, between a bank and a nondeposit investment product with a name similar to the bank's should be disclosed in appropriate advertising and marketing materials.

DISCLOSURES; ADVERTISING AND MARKETING

General

To ensure that customers are not confused about the uninsured nature of nondeposit investment products and are informed about the investment risks associated with such products, customers must be given adequate disclosures. Under certain circumstances (for example, sale of a bank's own securities), disclosures may have to be modified as appropriate.

Advertising and Marketing Disclosures

Advertising and promotional materials must be accurate and not misleading. Advertising and promotional, marketing, and sales materials given to customers should contain conspicuous and prominent notice that the product—

- is not a bank deposit,
- is not an obligation of, or guaranteed by, any bank,
- is not insured or guaranteed by the Federal Deposit Insurance Corporation or any other government agency, and
- involves investment risk, including the possible loss of principal.

In order to be conspicuous and prominent, the disclosures should be appropriately placed and in appropriate style and size of type so that the disclosures will not escape the customer's attention. For example, disclosures are not conspicuous and prominent if they are lost in the middle of a multi-page document or if they are in a typeface that is too small relative to the other typefaces used in the document.

Joint advertising or marketing of deposit and nondeposit investments should clearly distinguish FDIC-insured products from nondeposit investment products. Bank stationery (with the logo "Member FDIC") may be used, unless prohibited by state law, to send letters to customers regarding nondeposit investment products as long as the disclosures regarding the nondeposit, uninsured nature of the investments are included in the letter. At the same time, legends referring to "each depositor insured to $100,000" should not appear in letters to customers regarding uninsured investment products.

Before engaging in any joint advertising or marketing efforts, savings associations are cautioned to review a recent SEC no-action letter on the issue. *INVEST Financial Corp., August 27, 1993.*

"Advertising" means material published or designed for use in a newspaper, magazine, or other periodical, radio, television, telephone or tape recording, videotape display, signs or billboards, motion pictures, telephone directories (other then routine listings), or other public media. Under certain circumstances (for example, broadcast media), shortened disclosures may be appropriate. These disclosures must nevertheless be conspicuous and prominent to fit the facts and circumstances.

"Promotional, marketing and sales materials" means any written communication distributed or made generally available to customers or the public, including circulars, pamphlets, brochures, form letters, excerpts or reprints of advertisements, or other sales literature.

Oral Sales Presentations

Oral sales presentations should also include the previously listed disclosures.

Written Disclosures

At the time of investment account opening or initial purchase of a nondeposit investment product, customers should be informed in writing that nondeposit investment products—

- are not bank deposits,
- are not obligations of, or guaranteed by, any bank,
- are not insured or guaranteed by the Federal Deposit Insurance Corporation or any other government agency, and
- involve investment risk, including the possible loss of principal.

Acknowledgment Form

At the time of investment account opening or initial purchase of an uninsured product, banks should ask the customer to sign a written acknowledgment form stating that the customer has read and understands the written disclosures and any sales charges or other applicable fees or charges. A sample form of written acknowledgment is presented on page 17.

Sales Confirmations and Periodic Account Statements

When sales confirmations or periodic account statements are issued by the bank (particularly periodic account statements that include information on both insured and uninsured products), they should also contain the previously listed disclosures. Periodic account statements should clearly distinguish information regarding FDIC-insured products from information on nondeposit investment products.

Prospectuses

Prospectuses should be provided to customers as required by securities regulations. As required by the SEC, prospectuses on mutual funds sold by or through the bank must disclose prominently on the cover of the prospectuses that shares of the fund—

- are not bank deposits,
- are not obligations of, or guaranteed or endorsed by, any bank, and
- are not federally insured by the Federal Deposit Insurance Corporation, the Federal Reserve Board, or any other government agency.

In addition, disclosure regarding investment risk, including the possible loss of principal, should be provided to customers prior to, or concurrent with, prospectus delivery.

Continuing Disclosure Obligation

DSRs are reminded that the NASD has suggested that its members readvise their customers annually that, among other things, mutual fund shares purchased through banks are not deposits and are not FDIC-insured. *NASD Notice to Members, 93-87, December 1993.*

Bank as Adviser to a Mutual Fund

If the bank or a bank affiliate is an adviser to the mutual fund, the bank should orally disclose to the customer the nature of the advisory relationship. A bank that sells shares of a mutual fund advised by the bank or an affiliate should disclose in writing to the customer that—

- the bank or an affiliate acts as an adviser to the mutual fund,
- the bank or affiliate receives compensation from the mutual fund for the advisory services, and
- although the mutual fund is advised by the bank or an affiliate, investments in the mutual fund are not obligations of, or guaranteed by, the bank.

The existence of other material relationships between the bank or an affiliate and the mutual fund should also be disclosed in writing. These written disclosures may be satisfied through mutual fund prospectus delivery.

Annuities

Banks that underwrite annuities should disclose that relationship to the customer.

ADVERTISING AND MARKETING CONSIDERATIONS

Determine Who Is Doing the Speaking

In constructing an advertising and marketing campaign, it is essential that the campaign be focused on who (for example, the bank, the broker-dealer, or the mutual fund) is offering the product and service that is being advertised or marketed.

A bank can advertise and promote the services that it can lawfully offer its customers.

> For example, a bank may state in its advertisements that: "We make available to our customers XYZ family of mutual funds," "Our bank is pleased to have been selected to serve as the investment adviser to the bank's proprietary fund," or "Our bank investment specialists are trained to help you, the consumer, select the types of securities that will help you achieve your investment goals."

A bank cannot speak for the mutual fund, as the mutual fund has a separate corporate identity. Moreover, the mutual fund's shares are not bank products. The bank product, if any, is investment advice being offered to the bank's proprietary or private label registered fund.

> For example, a bank ad should not say: "**Our** mutual fund is highly suitable for your long-term investment needs" or "We are pleased to announce the launch of **our** mutual fund."

Bank ads may promote a financial supermarket theme.

> For example, bank ads can stress the abilities of the bank's investment specialists, a particular investment style, or some specific service or technology that the bank can offer.

Mutual fund and broker-dealer advertisements may describe the benefits of investing with their firm. Those advertisements are, however, subject to further regulation as outlined below.

> A mutual fund or a broker-dealer must follow rules of the SEC with regard to its advertisements and have its advertisements reviewed by the NASD. Appropriate attention by the fund or the broker-dealer must also be given to recent bank regulatory guidance with respect to retail sales of nondeposit investment products through banks.
>
> Mutual fund and broker-dealer advertisements are subject to the antifraud provisions of the federal securities laws. *See* Rule 156 under the Securities Act of 1933, 17 CFR 230.156; Rule 10b-5 under the Securities Exchange Act of 1934, 17 CFR 240.10b-5.

Under the federal securities laws, advertisements that offer any security for sale are deemed to be prospectuses. Section 5 of the Securities Act of 1933 prohibits the use of a prospectus to offer or sell a security unless a registration statement is in effect and the prospectus meets the requirements of Section 10 of the Securities Act. In order to comply with the prospectus delivery requirements of Section 5, a mutual fund advertisement must comply with either Rule 134 or Rule 482 under the Securities Act, 17 CFR 230.134 or 482, or be treated as sales literature and accompanied or preceded by a statutory prospectus.

Section 35 of the NASD's Rules of Fair Practice require members to file mutual fund advertisements with the NASD within 10 days of first use or publication. Filing in advance of use is highly recommended. Ordinarily, the fund's distributor is responsible for filing.

It is recommended that any advertising and promotional materials used by the bank be reviewed by bank management or counsel or, where appropriate, counsel to the mutual fund or broker-dealer.

SAMPLE INVESTMENT PRODUCT ACKNOWLEDGMENT

By my signature below, I acknowledge that I have read and understand the following features of my investment that have been checked by the Designated Sales Representative as applicable:

- ☐ The investment products I am purchasing are not bank deposits and are not obligations of, or guaranteed by, any bank. These products are not insured or guaranteed by the Federal Deposit Insurance Corporation or any other government agency.
- ☐ Where appropriate (for example, mutual funds and equities), I have received a current prospectus and understand the sales charges and other applicable fees or charges as disclosed in the prospectus.
- ☐ Sales charges and other applicable fees or charges regarding other investment products purchased have been disclosed.
- ☐ I understand that the investment products purchased are subject to investment risk, including possible loss of principal.
- ☐ Although payment of principal (at maturity) and interest on securities in U.S. government funds is guaranteed to the fund, the market value of the shares will fluctuate with rising or declining interest rates.
- ☐ An investment product's past performance should not be considered an indication of future results.
- ☐ Procedures for redeeming, surrendering or selling my investment may vary, depending on the investment selected, and have been disclosed.
- ☐ The investment products I am purchasing ARE/ARE NOT insured by the Securities Investors Protection Corporation ("SIPC"). SIPC coverage is not the same as the federal deposit insurance provided by the FDIC. It does not protect investors against a decline in the market value of securities. SIPC generally protects customers against the *physical loss* of securities if the broker/dealer *holding* the securities for the customer fails.

Name(s) as shown on account _____

Account # _____ Amount of initial investment _____

Investing in _____

Signed _____ Signed _____

Date _____

Recommended: Form to be in Triplicate (Copies to Accountholder, Branch Office, and Central Office)

SUITABILITY

Applicability to Registered Representatives

Registered broker-dealers should refer to the NASD's Rules of Fair Practice when drafting their own suitability compliance program. The following discussion on suitability is intended to assist those persons not governed by the NASD's Rules of Fair Practice.

General

Suitability as used in the financial context refers to the appropriateness of a particular investment, type of investment, or portfolio of investments to an investor, given the investor's unique circumstances.

Suitability encompasses not only suitability as it relates to the customer but also as it relates to investment products offered. A helpful suitability checklist would include consideration of—

- adoption of appropriate suitability guidelines;
- using appropriate product feature aids—brochures, charts, and so forth;
- requiring appropriate staff training; and
- conducting effective trade review (*see* Bank Management and Board of Directors Oversight section).

DSRs involved with the offer and/or sale of securities have an obligation of fair dealing under the general antifraud provisions of the federal securities laws and shall observe high standards of commercial honor and just and equitable principles of trade.

A suitability standard consistent with the NASD's Rules of Fair Practice should apply in all cases where investment advice is offered to bank customers. That advice may be provided only by trained and knowledgeable staff.

Suitable Recommendations to Customers

In recommending to a customer the purchase, sale, or exchange of any nondeposit investment product, a DSR should have reasonable grounds for believing that the recommendation is suitable for such customer upon the basis of the facts, if any, disclosed by such customer as to his or her other security holdings and as to his or her financial situation and needs.

"Know Your Customer"—Obtaining Customer Information

Prior to the execution of a transaction recommended to a retail customer, other than transactions where nondeposit investments are limited to money market mutual funds, a DSR shall make reasonable efforts to obtain information concerning the customer's financial background, tax status, personal and financial situation, investment objectives, tolerance for risk, and any other similar information concerning the customer.

- The existence of sales and redemption charges on mutual fund products may make material differences in the return on the investment under certain circumstances. A DSR should consider these and other similar features in assessing bank customers' goals and objectives.

Risk Diversification

Where appropriate, DSRs should consider risk diversification in making recommendations to customers.

Unsolicited Transactions

Unsolicited transactions may be executed on behalf of a customer, without regard to suitability, if so directed by the customer. A DSR may wish to consider the type of documentation necessary (for example, trade ticket, confirmation, etc.) to substantiate the trade as unsolicited.

For customers seeking discount brokerage service (that is, order execution only; no recommendation), transactions may be executed, without regard to suitability. A DSR may wish to consider the type of documentation necessary (for example, trade ticket, confirmation, etc.) to substantiate the trade as unsolicited.

Recordkeeping

A record for each account shall be maintained containing the following information:

- customer's name and residence;
- whether the customer is of legal age; and
- signature of the DSR and his or her supervisory person.

For all retail accounts, other than accounts limited to transactions in money market funds, DSRs shall make reasonable efforts to obtain, prior to settlement of the initial transaction in the account, the following information:

- tax identification or Social Security number;
- customer's occupation;
- name and address of employer; and
- information concerning the customer's financial background, tax status, personal and financial situation, investment objectives, tolerance for risk, and any other similar information concerning the customer.

Suitability Is *Not*

The following practices are inconsistent with the principle of suitability:

- trading in mutual fund shares, other than money market mutual funds, on a short-term basis;
- recommending the purchase of securities or the continuing purchase of securities in amounts that are inconsistent with the reasonable expectation that the customer has the financial ability to meet such ongoing financial commitment;
- guaranteeing a customer against loss in any securities transaction effected by the bank with or for such customer.
- recommending speculative low-priced securities to customers without knowledge of or an attempt to obtain information concerning the customers' other securities holdings, their financial situation, and other necessary data.

EMPLOYEE QUALIFICATIONS AND TRAINING

General

Bank management, DSRs, and audit and compliance personnel involved with the bank's investment product program should demonstrate competence appropriate to the function or responsibilities assigned to them by the bank's retail investment policies and procedures.

Background Checks

Background checks for all new DSRs who will be engaged in the offering and/or sale of nondeposit investment products are strongly recommended. Reviews of new employees with previous securities or insurance industry experience should include a check with appropriate authorities for possible prior disciplinary actions.

Licensing and/or Certification

When appropriate and possible, DSRs should obtain an appropriate NASD license, such as a Series 6 or 7. A NASD license equivalency certificate may also be appropriate.

Audit and Compliance Personnel

Employees responsible for compliance and/or auditing the bank's investment program should be competent and knowledgeable regarding the federal and state regulatory requirements for such programs.

Training

Industry trade groups should assist their members in obtaining appropriate training.

Bank management, DSRs, audit and compliance personnel involved with the bank's investment product program, and other bank employees should be offered training appropriate to the function or responsibilities assigned to them by the bank's retail investment policies and procedures.

Training should cover product knowledge, operational concerns, sales and advertising practices, compliance and regulatory issues, disclosure, and suitability and ethical considerations.

Continuing Education

Continuing education requirements ultimately adopted by the securities and insurance industries should also be adopted and modified, as necessary, by the banking industry.

EMPLOYEE COMPENSATION AND REFERRAL FEES

Bank Policy

A bank should have written policies governing the commissions, referral fees, and other compensation that the bank, its DSRs, and nonsales employees receive on the sales of nondeposit investment products.

Employee Compensation

Suitability, not compensation, should guide sales of nondeposit investment products. Banks are urged to cultivate a customer-oriented sales ethic: "If it's good for the customer, it's good for the bank."

Compensation of DSRs

Compensation for the sale of nondeposit investment products should be structured to avoid incenting the sale of unsuitable products.

DSRs should be free to offer customers a choice of investment products that provide different levels and types of compensation. For example, compensation may be commensurate with the amount invested, the duration of the investment, and the income generated to the bank by the investment. However, DSRs should not favor or disfavor the sale of a particular investment company, group of investment companies, or insurance company product based solely on the receipt of brokerage commissions or other incentives.

Referral Fees

Fees based on referrals may be structured so as to encourage tellers and other bank employees to appropriately increase customer awareness of the availability of all types of nondeposit investment products offered by their institutions.

Compensation to tellers and other bank employees for a referral should not be based on the success of the referral in generating a sale of a nondeposit product(s).

Tellers and other bank employees may be compensated based on individual or total referrals that result in customer meetings with DSRs.

BANK MANAGEMENT AND BOARD OF DIRECTORS OVERSIGHT

Overall Policy

A bank should establish and maintain written policies and procedures regarding retail sales of nondeposit investment products. Such policies and procedures should encompass third-party and affiliated vendor sales, sales of proprietary products, and sales of both third-party and proprietary products by bank personnel, as applicable.

Board of Directors ("Board") Responsibilities

Under the bank's policies and procedures, the Board should be responsible for—

- evaluating the risks posed by programs that offer nondeposit investment products (for example, loss of customers if products not offered; associated risks, if any, to insured bank's reputation posed by downturn in the securities markets; and capacity of bank to manage these and other risks);
- approving written policies and procedures; and
- delegating responsibility to bank management concerning retail sales of nondeposit investment products.

In determining bank management responsibilities, the Board may choose to retain for itself any of the responsibilities listed below, such as entering into third-party vendor agreements.

Bank Management Responsibilities

Bank management should establish, maintain, and enforce a system to manage its retail investment activities and those DSRs involved with offering nondeposit investment products to the retail public. Such a system should be reasonably designed to achieve compliance with applicable banking, securities, and insurance laws and regulations. Final responsibility for proper oversight should rest with bank management.

Oversight Program

At a minimum, an oversight program should be in writing and address the following:

Investment Product Selection.

- Specify what types of investment products the bank will sell and offer investment advice with regard thereto, and what policies and procedures will govern the selection and marketing of products. Such policy should include qualitative considerations, such as ratings by nationally recognized statistical rating organizations, investment philosophy supporting the product, and financial condition and stability of the investment product and its provider.

For example, a bank may wish to specify whether and under what circumstances and capacity (for example, bank or through broker-dealer) it will accept orders for equities and corporate debt securities and make available investments in commercial paper, U.S. government securities, municipal securities, repurchase agreements, and banker's acceptances.

- Make available a suitable array of investment products to bank customers.

  For example, those banks offering mutual funds to customers should offer a variety of choices, that is, funds whose investment objectives vary.

Allocation of Responsibilities Among Parties.

- Outline responsibility for each activity or function specified in the sales policy and specifically assign responsibility for such activity or function to an individual employed by the bank, a third-party vendor, or an affiliated broker-dealer, including:

  —designating supervisory person(s) to supervise, review, and endorse transactions in accounts handled by DSRs and to specifically approve the opening of new customer accounts;

  In this connection, supervisory person(s) should maintain a customer account file that includes all written and verbal complaints, if any, and should adequately investigate such complaints.

  —designating supervisory person(s) to review sales literature, advertisements, radio and television presentations, seminar presentations, and outgoing correspondence regarding retail sales of investment products.
- Require participation of each DSR, either individually or collectively, no less than annually, in an interview or meeting conducted by appropriately qualified persons at which compliance matters relevant to the activities of the DSR(s) are discussed.

Customer Information.

- Specify bank's policies governing the permissible uses of bank customer information in connection with the marketing and sale of investment products.

Vendor Agreements

Bank management should be responsible for entering into governing agreements with third-party vendors and affiliated broker-dealers. Such agreements should clearly outline the duties and responsibilities of all parties, including the responsibility of third-party vendors and affiliated broker-dealers, to—

- issue appropriate disclosures to retail customers,
- comply with appropriate suitability standards,
- establish appropriate compensation programs,
- perform background checks on and train appropriate personnel,
- monitor compliance with applicable law, and
- maintain appropriate account records regarding the sale of nondeposit investment products sold through the bank.

In addition, such agreement should include provisions regarding bank oversight of all bank-related retail sales by such party, as well as examiner access to appropriate records.

Bank-Affiliated Mutual Funds

Bank management should be responsible for taking appropriate precautions regarding bank-related retail sales of bank- or bank affiliate-advised mutual funds. Such precautions should include orally disclosing to the customer the nature of the advisory relationship and disclosing in writing that—

- the bank or an affiliate acts as an adviser to the mutual fund;
- the bank or affiliate receives compensation from the mutual fund for the advisory services, and
- although the mutual fund is advised by rhe bank or an affiliate, investments in the mutual fund are not obligations of, or guaranteed by, the bank.

The existence of other material relationships between the bank or an affiliate and the mutual fund should also be disclosed in writing. These written disclosures may be satisfied through mutual fund prospectus delivery.

Insurance Coverage

Prior to embarking on a sales program for nondeposit investment products, bank management should notify their blanket bond carriers of their plans to engage in these activities. Written assurance should be obtained that staff representing third-party and affiliated vendors have appropriate insurance coverage.

Compliance Program

A compliance program, independent of investment product sales and management, should be established. The program should be capable of verifying compliance with banking, securities, and insurance laws and regulations. The compliance function should also include a system to monitor customer complaints and to review periodically customer accounts, including spot checking, to detect and prevent abusive practices. Appropriate corrective actions should be implemented when necessary.

As part of a compliance program, a bank may wish to consider establishing a targeted call back program, a mystery shopper program, or some other method of monitoring compliance with the bank's policies and procedures. A targeted call back program could be designed to call certain customers shortly after they have opened an investment account with the bank to determine if the bank's policies and procedures were satisfied.

A bank may wish to consider building into its procedures for opening customer accounts an agreement between the customer and the bank to submit any disputes that arise to arbitration. A sample arbitration agreement is presented on page 35.

Insider Trading

To avoid liability under the federal insider trading laws, banks should establish policies and procedures to prevent insider trading. (Broker-dealers are required to have policies and procedures.) Insider trading refers to the purchase or sale of securities while in possession of material, nonpublic information that would be important to an investor in making a decision whether to purchase or sell securities. The federal securities laws impose liability on employers, including banks, as well as their officers, directors, and supervisory personnel for illegal insider trading activities of their employees.

Liability can result in civil fines of $1 million or three times the profits gained or losses avoided, whichever is greater. Criminal penalties for insider trading violations can also result, which may include maximum monetary penalties of $2.5 million. Thus, if a bank employs an individual who trades on inside information, the bank and its directors, as controlling persons, may be liable for civil and criminal penalties in excess of $3.5 million. In addition, jail terms of ten years can result.

Liability can also result when an employee commits tipping violations. Specifically, a bank may be liable even if an employee does not trade on inside information but communicates such information to another individual who trades on the basis of that information.

ARBITRATION

Banks may wish to resolve any disputes with customers involving securities transactions through arbitration. Arbitration is a dispute resolution mechanism whereby the parties to the dispute set forth their positions before either a single arbitrator or a panel of arbitrators, who then render a decision. That decision is binding on the parties. Generally arbitration is faster and less expensive than litigation.

The securities industry uses arbitration extensively. The NASD, the NYSE, the American Stock Exchange ("AMEX") and the Municipal Securities Rulemaking Board ("MSRB") all have established rules and procedures for securities arbitration. Banks using registered broker-dealers, either affiliated or unaffiliated, to sell securities through the bank to the retail public would generally use the rules and procedures of one of these organizations. For banks not using registered representatives to sell securities to the retail public, the rules and procedures of the American Arbitration Association ("AAA") are available.

Arbitration is voluntary, so both the bank and the customer must agree to arbitrate. That agreement can be obtained either before or after any dispute arises. A sample agreement to arbitrate is presented on page 35. If a bank wishes to obtain the agreement pre-dispute, it should be obtained at the time the customer account opening forms are signed. An arbitration provision may be incorporated into the account opening agreement. It should be noted, however, that the securities industry generally uses pre-dispute arbitration agreements for margin and options accounts.

Finally, while arbitration is less expensive than litigation, it does involve some expenditure of funds. Each organization has its own fee structure and should be consulted.

For more information, contact the Director of Arbitration at one of the following organizations:

American Arbitration Association
140 West 51st Street
New York, New York 10020
212/484-4000

American Stock Exchange, Inc.
86 Trinity Place
New York, NY 10006
212/306-1000

Municipal Securities Rulemaking Board
1818 N Street, N.W.
Washington, DC 20036
202/223-9347

National Association of Securities Dealers, Inc.
33 Whitehall Street
New York, NY 10004
212/858-4400

New York Stock Exchange, Inc.
11 Wall Street
New York, NY 10005
212/656-2772

SAMPLE AGREEMENT TO ARBITRATE

I/we understand and acknowledge that:

- Arbitration is final and binding on the parties.
- _____ (The name of the Bank or Broker offering investment services) and I/we are waiving our right to seek remedies in court, including the right to a jury trial.
- Pre-arbitration discovery is generally more limited than and different from court proceedings.
- The arbitrators' award is not required to include factual findings or legal reasoning, and any party's right to appeal to a court of law or to seek modification of rulings by the arbitrators is strictly limited.
- The panel of arbitrators will typically include a minority of arbitrators who were or are affiliated with the securities industry.

I/we hereby agree that all controversies which may arise between us, including but not limited to those involving any transaction or the construction, performance, or breach of this or any other agreement between us, including the Investment Product Acknowledgment, whether entered into prior to, on, or subsequent to the date hereof, shall be determined by arbitration. Any arbitration under this Agreement shall be conducted only before _____ * and in accordance with its securities arbitration rules then in force. Judgment upon the award of the arbitrators may be entered in any court, state or federal, having jurisdiction.

By signing this Agreement below, I/we hereby consent and agree to the terms and conditions set forth herein.

Customer's Name _____

Customer's Signature _____

Co-Owner's Name (if applicable) _____

Co-Owner's Signature (if applicable) _____

Bank or Broker name _____

by Designated Sales Representative _____

Date _____

*The National Association of Securities Dealers ("NASD") and the Stock Exchanges, e.g., New York Stock Exchange ("NYSE"), have established arbitration procedures and agreements for registered brokers. By and large, this sample agreement envisions using the procedures and forms of the NASD, NYSE, etc., if a registered broker-dealer is conducting the sale on bank premises. If, however, a qualified bank employee, not a registered broker-dealer, conducts the sale, the procedures and forms of the American Arbitration Association are available. Contact your local AAA office or national AAA headquarters (140 West 51st Street, New York, NY 10020-1203) for guidelines and procedures.

CONSIDERATIONS FOR SELECTING THIRD-PARTY PROVIDERS AND INVESTMENT PRODUCTS

While not exhaustive, the following factors are important and should be taken into account when a bank undertakes to choose a product or service provider.

Financial Strength Standards

The financial health of product and service providers is of fundamental importance to investors. Therefore, the bank should evaluate the financial strength of such providers to determine whether they will be able to meet their financial commitments.

Adequacy of Regulatory Oversight

Third parties are subject to the regulatory oversight of both national and state agencies. Therefore, the bank should initially and periodically review the record of regulatory compliance by both the provider corporation and its sales representatives.

Ongoing Commitment to the Product

A bank should review the third-party and/or product provider's capacity and willingness to maintain its commitment to the business and to the product.

Clear Product Features/Pricing

The products to be sold should be competitive with other similar products; terms and conditions should be clear and easy to understand.

Consumer Disclosures and Protection

The third-party provider should adhere to these guidelines in all aspects. Consistent with these guidelines, the third-party provider should incorporate disclosures into the sales process, adopt procedures so that the right products are sold to the right customers, and have established an appropriate compliance program.

Consistent Implementation Oversight

Implementation activities by the third-party provider should be consistent with and support the bank's overall goals and objectives, its ethical standards, and its corporate and investment product strategies.

Review

A review should be conducted initially by the bank before offering an investment product and periodically while the product is being offered to bank customers. Similarly, a review should be conducted initially by the bank before entering into an agreement with a third-party provider and, periodically, during the length of the contractual relationship.

OCC 94-13

OCC BULLETIN

Comptroller of the Currency
Administrator of National Banks

Subject: Nondeposit Investment Sales Examination Procedures

Description: Temporary Insert — *Handbook for National Bank Examiners*

TO: All Users of the *Comptroller's Handbook for National Bank Examiners*

PURPOSE

This issuance transmits a new section 413, Retail Nondeposit Investment Sales, for the *Comptroller's Handbook for National Bank Examiners*. This section should be inserted in the handbook at the end of the "Other Areas of Examination Interest" section, behind section 412, Discount Brokerage Activity.

REFERENCES

Banking Circular 274, Retail Nondeposit Investment Sales, is rescinded and replaced by new section 413 to the *Comptroller's Handbook for National Bank Examiners*, dated February 1994, attached.

BACKGROUND

On July 19, 1993, the Office of the Comptroller of the Currency issued Banking Circular 274, Retail Nondeposit Investment Sales, which provided guidelines for national banks involved in the sale to retail customers of mutual funds, annuities, and other nondeposit investments. Those guidelines were superseded on February 15, 1994, by the issuance of an Interagency Statement, developed by the OCC, the Federal Reserve Board, the FDIC, and the OTS. The Interagency Statement will apply uniform standards to federally insured financial institutions offering these services.

SCOPE

The Interagency Statement is incorporated in this insert, which provides national bank examiners with procedures for examining the nondeposit investment sales activities of national banks. The questions and procedures presented here check for compliance with the Interagency Statement as well as laws, rules, and regulations. They also provide national bank examiners with a basis for evaluating management and controls in this type of operation.

RESPONSIBLE OFFICE

Questions concerning the Interagency Statement or any part of the insert may be directed to the Office of the Chief National Bank Examiner, Capital Markets Group, in Washington, DC at (202) 874-5070.

Susan F. Krause

Susan F. Krause
Senior Deputy Comptroller for Bank Supervision Policy

Enclosure

Retail Nondeposit Investment Sales

Introduction

This section sets forth guidance for examiners reviewing bank nondeposit investment product retail sales operations, including bank-related marketing and promotional activities. Examiners will review a bank's programs for consistency with the Interagency Statement on Retail Sales of Nondeposit Investment Products, dated February 15, 1994 (Interagency Statement). The evaluation will cover all bank-related activities including:

- Sales or recommendations made by bank employees;
- Sales or recommendations made by employees of affiliated or unaffiliated entities occurring on bank premises (including sales or recommendations initiated by telephone or by mail from bank premises); and
- Sales resulting from referrals of retail customers to a third party when the bank receives a benefit for the referral.

When reviewing a bank's nondeposit investment sales operation, examiners should determine that the bank views customers' interests as critical to all aspects of its sales programs. Examiners should evaluate a bank's policies and procedures from the customers' perspective and should ascertain that customers are provided with a high level of protection. If it becomes necessary to recommend remedial action, examiners should determine that bank management responds immediately to any matter that has the potential to confuse customers as to the uninsured nature of nondeposit investment products.

Banks that do not operate programs safely and soundly or that engage in violations of law or regulations will be subject to appropriate regulatory action. When determining the appropriate action, examiners should be mindful that some banks, especially banks relying on third parties for sales of nondeposit investment products, may need time to conform their programs to the Interagency Statement and to the guidance contained herein. At a minimum, however, examiners should determine whether bank management is making a good faith effort to comply with this regulatory guidance in a timely manner.

This section applies to sales to individual customers but does not apply to the wholesale sale of nondeposit investment products to non-retail customers, such as sales to institutional customers or to fiduciary accounts administered by an institution. As part of its general responsibilities, however, a national bank should take appropriate steps to avoid potential customer confusion when providing nondeposit investment products to institutional customers or to the bank's fiduciary customers. For additional information on restrictions on a national bank's use as fiduciary of the bank's brokerage service or other entity with which the bank has a conflict of interest, including purchases of the bank's proprietary and other products, see 12 CFR 9.12 and "Sales to Fiduciary Accounts," later in this section.

Scope

Examiner reviews of a bank's mutual fund or other nondeposit investment sales program will concentrate on the policies and procedures the bank adopts and on the effectiveness of their implementation.

When reviewing implementation of a bank's program, examiners will investigate whether senior bank management has:

(1) Participated in planning the bank's investment sales program;

(2) Adopted a framework to ensure compliance with all applicable laws, rules, regulations, regulatory conditions, and the Interagency Statement; and

(3) Ensured effective supervision of individuals engaged in sales activities, including employees of the bank and any other entity involved in bank-related sales of investment products.

Where relevant, references in this handbook section to bank management or bank employees includes third party managers or third party employees.

Retail Nondeposit Investment Sales

Minimum Standards for Nondeposit Investment Programs

Antifraud provisions of the federal securities laws prohibit materially misleading or inaccurate representation in connection with offers and sales of securities. (See, for example, Section 10 of the Securities Exchange Act of 1934 and Rule 10b-5.) If customers are misled about the nature of nondeposit investment products, including their uninsured status, sellers could face potential liability under these antifraud provisions. Safe and sound banking also requires that bank-related retail sales activities be operated to avoid confusing customers about the products being offered. Use of nonbank employees to sell these products does not relieve bank management of the responsibility to take reasonable steps to ensure that the investment sales activities meet these requirements.

The Rules of Fair Practice of the National Association of Securities Dealers (NASD) expressly govern sales of securities by broker/dealers who are members of NASD. These rules apply to bank-related securities sales by banking subsidiaries registered as broker/dealers, affiliated broker/dealers, and unaffiliated broker/dealers operating under agreements with banks. These rules apply whether such sales are made on bank premises or at a separate location.

These rules do not expressly apply to sales or recommendations made directly by the bank. Even when these rules do not expressly apply, however, they are an appropriate reference for a bank compliance program designed to ensure that the bank's retail sales of all nondeposit investment products are operated in a safe and sound manner.

Before beginning to operate a nondeposit investment sales program, banks may also consider notifying their blanket bond carriers of plans to engage in these activities. If applicable, this could permit the bank to obtain written assurances from the carrier that the bank's insurance coverage for employees includes staff representing third party vendors.

Examiners also should encourage bank management to review *Retail Investment Sales: Guidelines for Banks*. The publication, prepared jointly by six banking industry trade associations, contains voluntary guidelines for bank sales of nondeposit investment products as well as common sense suggestions for putting many of the OCC's recommendations into action.

Program Management

Banks must comply with all applicable laws, rules, regulations, and regulatory conditions, and operate consistently with the Interagency Statement for any of their bank-related retail sales of mutual funds, annuities, or other retail nondeposit investment products. Bank directors are responsible for evaluating the risks imposed by bank-related sales and are expected to adopt a program statement and self-regulatory policies and procedures to ensure compliance with all requirements. A bank's policies and procedures must address bank-related retail sales made directly by a bank, through an operating subsidiary or affiliate, or by an unaffiliated entity.

Examiners should expect that banks will tailor their policies and procedures to the scope of the bank's sales activities. The level of detail contained in a bank's policies and procedures will depend on the structure and complexity of the bank's program.

Examiners will review the bank's securities sales activities to determine that the bank has adopted a statement that addresses the risks associated with the sales program and describes the features of the sales program, the roles of bank employees, and the roles of third party entities. The statement should set forth the strategies the bank will employ to achieve its objectives. It also should outline the self-regulatory procedures bank management will implement to ensure that the program's objectives are met without compromising the customers' best interests.

Retail Nondeposit Investment Sales

Introduction

At a minimum, examiners should expect bank policies and procedures to address:

Supervision of personnel involved in nondeposit investment sales programs — Senior bank managers will be expected to ensure that specific individuals employed by the bank, an affiliated broker/dealer, or a third party vendor are responsible for each activity outlined in the bank's policies and procedures. Managers of the bank's securities sales activities will be accountable for understanding the investment products offered and the sales process, as well as for assuring compliance with securities and banking laws, rules, and regulations.

Designation of employees authorized to sell investment products — This should serve as a guide for all bank-related employees dealing with retail nondeposit investment product customers. The program statement should specify that only properly trained and supervised employees are permitted to make investment sales or recommendations. It should describe the responsibilities of personnel authorized to sell or recommend nondeposit investment products and of other personnel who may have contact with retail customers concerning the sales program. It also should include a description of appropriate and inappropriate referral activities and the training requirements and compensation arrangements for each category of personnel.

The roles of other entities selling on bank premises, including supervision of selling employees — Bank management must plan to monitor compliance by other entities on an ongoing basis. The degree of bank management's involvement should be dictated by the nature and extent of nondeposit investment product sales, the effectiveness of customer protection systems, and customer responses. (*See* "Third Party Vendors," later in this section for more details on programs operated by third parties.)

The types of products sold — Policies and procedures should include the criteria the bank will use to select and review each type of product sold or recommended.

For each type of product sold by bank employees, the bank should identify specific laws, regulations, regulatory conditions, and any other limitation or requirements, including qualitative considerations, that will expressly govern the selection and marketing of products the bank will offer. (*See* "Product Selection," later in this section for further discussion of these issues.)

Examiners should review:

- The process the bank uses to select the products it will offer,
- What the bank did to ensure the products meet its customers' needs and expectations, and
- How well the bank is performing an ongoing analysis of the appropriateness of the products offered for sale.

Examiners will also assess the independence and thoroughness of the analysis and the degree to which the bank relies on ratings services. Examiners should be critical of bank managers who simply choose products that generate the largest sales fees or accept what a third party has to offer without performing an independent analysis of the suitability of the products to the bank's strategy and customer mix.

Examiners should not give the impression that the agency expects bank managers to be "stock pickers" or that it intends to expand or limit the types of products banks offer. Instead, examiners should determine that bankers are selecting products that generally meet their customers' needs.

(*See* "Third Party Vendors," later in this section, for more details on the bank's oversight roles when it relies on its third party vendor to select products.)

Policies governing the permissible uses of bank customer information — Examiners should determine that bank customer information policies address the permissible uses of such information for any purpose

associated with bank-related retail investment sales activity. In particular, if the bank intends to use customer lists to telephone depositors whose certificates of deposit are due to mature to inform them about alternative investment products, the policies should outline steps the bank will take to avoid confusing customers as to the risks associated with nondeposit investment products, including their uninsured nature.

Banks may also supply customer information lists to a third party vendor. Supplying such information should only occur, however, after bank management has evaluated steps the third party is taking to avoid confusing customers and after determining such steps are consistent with bank policy.

Bank management also may wish to consider obtaining a legal opinion concerning the bank's authority to share customer information with third parties.

Communications with customers — Examiners should determine whether the bank's policies consider the need for periodic and ongoing communications with customers to help them understand their investments and to remind customers periodically that the products they have purchased are not insured deposits. Policies should outline customer communications for the bank during periods of market stress and assign responsibilities for such communications.

Setting and Circumstances of Nondeposit Investment Product Sales

Banks should market nondeposit products in a manner that does not mislead or confuse customers as to the nature of the products or their risks. The setting and circumstances surrounding sales of investment products is fundamental to ensuring that customers can readily distinguish between nondeposit investment products and insured deposits. Examiners will determine that bank management has established controls to distinguish retail deposit-taking activities from the promotion, sale, and subsequent customer relationships related to retail nondeposit investment sales.

To minimize customer confusion, sales of, or recommendations for, nondeposit investment products on the bank's premises should be conducted in a physical location distinct from the area where retail deposits are taken. Signs or other means should be used to distinguish the investment sales area from the retail deposit-taking area of the institution.

In the limited situation in which physical considerations prevent nondeposit investment product operations from being conducted in a distinct area of the bank, a bank has a heightened responsibility to ensure that measures are in place to minimize customer confusion. To minimize customer confusion, the bank should make an officer responsible for each of the locations at which the investment product sales will take place.

The bank also should employ signs and, where possible, separate desks and personnel for deposit-taking and investment product sales. Investment product salespeople should clearly identify themselves by the use of appropriate methods such as name tags or separate business cards. In banks where the investment program is likely to be less elaborate, the examiner should determine, at a minimum, that the bank utilizes the written and oral disclosures described below.

In no case should any employee, while located in the routine deposit-taking area, such as the teller window, make general or specific investment recommendations regarding nondeposit investment products, or accept orders for such products, even if unsolicited. Tellers and other employees who are not authorized to sell nondeposit investment products may only refer customers to individuals who are specifically designated and trained to assist customers interested in the purchase of such products.

Retail Nondeposit Investment Sales

Introduction

Product names — Banks may not offer nondeposit investment products with a product name identical to the bank's name. Names that imply that mutual funds are U.S. government guaranteed also are prohibited.

Banks also should recognize that the potential for customer confusion may be increased if the bank offers nondeposit product names that are similar to the bank's name. If the bank offers such nondeposit products with names similar to the bank's, it should design sales training programs to minimize the risk of confusing customers.

In addition, Securities and Exchange Commission (SEC) staff have issued an opinion that common names between a bank and a mutual fund sold or marketed by or through that bank are presumed to be misleading and a violation of the Investment Company Act of 1940. SEC staff contends, however, that a common name fund can rebut the presumption that a fund's name is misleading by ensuring that the cover page of the prospectus prominently discloses that the fund's shares are not deposits or obligations of the bank and are not federally insured.

When examining investment sales programs in a bank that is selling funds with names similar to the bank's, examiners will evaluate the steps that bank management has taken to avoid confusing customers. The greater the similarity between bank and fund names, the more closely examiners will scrutinize all aspects of a bank's sales program.

Examiners should criticize sales programs in which fund names are so similar to the bank's that even mitigating circumstances are unlikely to eliminate customer confusion. For example, it may be acceptable for "First National Bank" to offer a nondeposit investment product named "First Fund" as long as the bank has implemented sufficient disclosures, training, and other measures to mitigate customer confusion. Other names, however, such as "First Bank Fund" or "First National Fund" are so similar to a bank's name that they are inappropriate because they are inherently confusing.

Examiners and bank management should also be aware that the potential for customer confusion can depend on the context in which the sales are taking place. For example, it may be inappropriate for the First National Bank to offer a mutual fund product named "FNB Money Market Fund" if First National Bank were also offering an insured deposit product named "FNB Money Market Account."

Overall setting and circumstances — When reviewing nondeposit investment product sales operations, examiners should not place undue weight on a single aspect of the setting and circumstances of the sale. Each bank's sales program is different, and one set of rules may not cover all circumstances or provide all customers with the necessary level of protection. Before judging a particular bank's operations, examiners should consider how the various elements of the program interact and whether the elements combined mislead or avoid misleading customers.

The following example illustrates how the combination of certain elements can potentially mislead customers:

> An employee of the First National Bank sits at a desk in the lobby. This employee sells money market mutual funds and renews CDs. The employee tells customers about two products the bank is offering: the FNB Money Market Fund, an uninsured retail nondeposit investment product, and the FNB Money Market Account, an insured deposit. This employee may have an incentive to market the uninsured product because the employee gets a commission for selling a mutual fund but receives nothing for selling or renewing a deposit.

This situation could confuse customers. To mitigate customer confusion, the bank should ensure that the employee has extensive knowledge of the products being sold and that the employee is thoroughly aware

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of customer protection issues. When selling noninsured products, the employee should also require customers to sign a new account form acknowledging that the product is not insured.

If space and personnel limitations appear to increase the potential for customer confusion, examiners should encourage bank management to require additional training and disclosures, to develop signs and product names that clearly distinguish among the products being sold, and to assure that compensation for selling uninsured and insured products is equalized. Examiners should expect banks with nondeposit investment sales programs already in operation when this section is issued to initiate actions immediately to conform all aspects of the setting and circumstances of the bank's program to these requirements. In particular, banks should take immediate steps to correct any elements that could confuse customers.

Disclosures and Advertising

Disclosures

Complete and accurate disclosure must be provided to avoid customer confusion as to whether a bank-related product is an investment product or an insured bank deposit. Examiners should determine that banks selling, advertising, or otherwise marketing nondeposit investment products to retail customers provide the following product disclosures conspicuously: The products offered (1) are not FDIC insured, (2) are not deposits or other obligations or guarantees of the bank, and (3) involve investment risks, including possible loss of principal amount invested.

The minimum disclosures should be provided to the customer:

- Orally during any sales presentation.
- Orally when investment advice concerning nondeposit investment products is provided.
- Orally and in writing prior to or at the time an investment account is opened to purchase these products.
- In advertisements and other promotional materials, as described below.

Examiners will determine whether these disclosures are featured conspicuously in all written or oral sales presentations, advertising and promotional materials, prospectuses, confirmations, and periodic statements that include the name or the logo of the bank or an affiliate.

Advertisements and brochures also should feature these disclosures at least as large as the text describing the bank's nondeposit investment products. The OCC believes that these disclosures are conspicuous when they appear on the cover of a brochure or on the first part of relevant written text. A bank's disclosures could also be considered conspicuous if it prints the required disclosures in a box or by displaying them in bold type or with bullet points.

The bank should obtain a signed statement acknowledging such disclosures from customers at the time a retail nondeposit investment account is opened. For accounts established before issuance of this section, the bank should consider obtaining such a signed statement prior to the next sale. If the bank solicits customers by telephone or mail, it should be assured that customers agreeing to purchase nondeposit investment products receive the disclosure acknowledgement form when they open a new account. A bank should also request all customers who previously opened investment accounts by mail without receiving these written disclosures to sign and return a disclosure acknowledgement to the bank.

Confirmations and account statements for nondeposit investment products should contain at least the minimum disclosures if the confirmation or account statement contains the name or logo of the bank or its affiliate. If a customer's periodic deposit account statement includes account information about nondeposit investment products, the bank should clearly separate that information from information about the deposit account. The material on the cus-

tomer's periodic deposit account relating to nondeposit investment products also should begin with the disclosures described above as well as the identity of the entity conducting the nondeposit transaction.

Where applicable, examiners should determine that the bank has made additional disclosures described in the Interagency Statement regarding affiliate relationships and specific fees and penalties.

Some disclosure obligations may arise from the roles a bank or a bank affiliate may play in the distribution, administration, and/or management processes. For example, a bank should disclose remuneration received for performing investment advisory services and administrative services such as shareholder accounting. This disclosure obligation may be met through fee disclosures in a prospectus. If the prospectus does not include such fee disclosures, the bank must make the disclosures by some other means. State law requirements may also govern fee disclosures.

Additional disclosure responsibilities may occur because of the manner in which nondeposit investment products are marketed. Examiners should determine whether public statements about the selection of the products a bank offers are reasonable. As an example, if management represents to customers that it has performed an independent analysis of the product selected, the examiner should determine that the bank has actually done so. Examiners will also evaluate management's disclosure to prospective customers of ratings applicable to a particular product, including the source of the rating. If ratings are used to promote certain products, examiners should expect bank management to review whether the bank will disclose ratings changes and, if so, determine how such disclosures will occur.

Examiners should also determine whether a bank-related sales program includes any written or oral representations to customers concerning insurance coverage provided by any other entity apart from FDIC, *e.g.*, the Securities Investor Protection Corporation (SIPC), a state insurance fund, or an insurance company. If these types of representations are made, examiners should determine whether training concerning differences in insurance coverage is provided to appropriate personnel. Appropriate personnel includes anyone who is likely to respond to customer inquiries or individuals designated to sell such products. Examiners should also determine if written or oral explanations of the differences in coverage are provided to all customers.

Advertising

Examiners should assess the procedures the bank uses to ensure that bank-related sales advertisements are accurate, do not mislead customers about the nature of the product, and include required disclosures. For example, claims about "no fees" or "no charges" are not accurate if the selling bank collects fees for investment advisory services or collects fees for shareholder accounting on the product or service being advertised. In this case a bank could claim that there are no "sales" charges and inform readers that a description of other charges is contained in the prospectus.

Examiners should determine that the bank does not imply in advertising or in written and oral presentations that the bank stands behind an investment product.

The bank's marketing department should not be solely responsible for bank-related investment sales advertisements. The issuer, or, if a mutual fund, the distributer, may prepare advertisements of specific investment products that conform to standards developed by self-regulatory organizations such as NASD. Senior bank management should appoint an officer responsible for ensuring that bank investment advertisements as well as advertisements prepared by another party that make reference to the bank, or any advertisement used in bank-related sales, are accurate, not misleading, and include all required

disclosures.

Suitability

Consistent with the Rules of Fair Practice, the OCC expects banks to determine whether a product being recommended is an appropriate investment for the customer. Banks should ensure that any salespeople involved in bank-related sales obtain sufficient information from customers to enable the salesperson to make a judgment about the suitability of recommendations for particular customers. At a minimum, suitability inquiries should be made consistent with the Rules of Fair Practice concerning the customer's financial and tax status, investment objectives, and other factors that may be relevant, prior to making recommendations to the customer. This information should be documented and updated periodically.

A well-documented suitability inquiry can protect a bank from dissatisfied customers who threaten litigation. Such litigation could introduce risk to the bank's capital. Accordingly, the OCC may view banks operating a retail securities business without appropriate suitability procedures to be engaging in an unsafe and unsound practice.

Many banks use software programs that document investor profiles to assist in making suitability judgments. Each profile is based on a customer's responses to inquiries as to his or her financial and relevant personal history. The software program subsequently matches the customer's investment needs and objectives to the bank's available products. This type of software is a tool, not a substitute for professional judgement; it should not weight bank proprietary products too heavily or bank deposits too lightly.

One example of a critical suitability determination involves sales to elderly bank customers. Many of these customers rely upon investments or savings for retirement income and may consequently demand high yields. They may not, however, have the ability to absorb or recover losses. A nondeposit investment salesperson should also be aware that it is especially important to make a careful suitability recommendation when dealing with a surviving spouse who is not experienced in investment matters.

Examiners should investigate potential suitability problems in mutual fund sales when reviewing "breakpoints" and "letters of intent." Breakpoints are discounts that are available to investors who purchase a large amount of mutual fund shares in a lump sum or as part of a cumulative investment program (*e.g.* under a "letter of intent"). The potential for abuse usually occurs when the sale of several different mutual fund shares takes place in quantities just below the level at which the purchaser would qualify for reduced sales charges on any one of the funds.

Examiners should determine whether a bank officer has been assigned responsibility for implementing and/or monitoring the suitability system. The examination approach should focus on the system the bank has in place to make suitability inquiries, suitability judgements, and periodic account reviews. Examiners generally should review sales patterns rather than individual sales for suitability issues. To determine the types of sales to test for suitability, examiners should investigate marketing programs that target a class of customers, customer complaints, sales to first-time and risk-averse investors, sales made by high- or low-volume salespersons, volatile and new products, and the existence of mutual fund redemptions after relatively short holding periods.

Qualifications and Training

Banks should implement detailed training programs to ensure that sales personnel have thorough product knowledge (as opposed to simple sales training for a product) and understand customer protection requirements. Examiners should assess the process the bank uses to ensure that sales personnel are properly qualified

and adequately trained to sell all bank-related nondeposit investment products. If bank personnel sell or recommend securities, the training should be substantively equivalent to that required for personnel qualified to sell securities as registered representatives. Securities industry training is available in most metropolitan areas.

Examiners also should determine that the bank's audit and compliance personnel and persons with supervisory responsibilities are properly trained and knowledgeable.

A bank's hiring practices and training plan should be designed around the complexity and risks of the particular investment products being offered. While it may be appropriate to have a banking generalist with no securities industry background sell money market mutual funds, it could be inappropriate to allow this individual to sell fixed-rate annuities without extensive training.

If individuals with securities industry experience are hired to sell investment products for banks, they should have an understanding of securities industry customer protection and control systems and have an adequate knowledge of the products being offered. Since they may not be familiar with general banking regulations and may not understand the needs of bank customers, banks should also ensure that these individuals are instructed as to the specialized obligations of selling investment products in a retail banking environment. Examiners should expect management to check with securities regulators to determine if potential bank sales employees with previous securities industry experience have a disciplinary history.

Banks engaging in lower volume mutual fund and annuity sales frequently train existing bank employees to sell investment products. Examiners should determine that bank management is satisfied that these individuals have acquired "product knowledge," and thoroughly understand the need to safeguard the customers' interests. More specialized "product knowledge" training is generally provided by the marketing division of a mutual fund sponsor or another third party vendor. Bank staff should also receive customer protection and compliance training.

Examiners should determine whether a bank officer has been assigned responsibility for ensuring that adequate training is provided to bank staff, and for reviewing the hiring and training practices of a third party vendor.

Compensation

Incentive compensation systems, which are standard in the securities and insurance businesses, are becoming increasingly common in commercial banking. Personnel who are authorized to sell nondeposit investment products may receive incentive compensation, such as commissions, for transactions entered into by customers. However, incentive compensation programs must not be structured in such a way as to result in unsuitable recommendations or sales being made to customers.

An improperly designed compensation system can provide a bank employee with the incentive to place his or her own compensation interests above the interests of bank customers. Examiners should assess the steps management has taken to ensure that compensation programs do not operate as an incentive for salespeople to make unsuitable recommendations or sales to customers.

One way to avoid having the compensation system drive the recommendation toward mutual funds and away from certificate of deposit renewals would be to separate the nondeposit investment product sales and CD renewal functions. Alternatively, if employees are permitted to offer both deposits and nondeposit investment products, a bank could reduce the temptation by compensating the employee for renewing maturing deposits as well as for selling nondeposit investment products. Examiners should discuss with bank management where appropriate the methods used to avoid possible conflicts of interest poten-

tially arising from the bank's compensation plan.

To investigate whether incentive compensation schemes could induce salespersons to recommend products with higher commissions over a more suitable option, examiners should look to customer complaints and to sales patterns rather than to individual sales. For example, an examiner can look for instances in which sales for a particular product increased after changes to an incentive compensation system.

Examiners also should expect a bank to increase its supervision of sales programs as it increases its incentive compensation. Examiners should be critical of supervision that does not take into account the possibility that recommendations for purchases of nondeposit investment products could be influenced by the incentive compensation scheme.

If the overall setting and circumstances of a bank's investment sales program appears to be only marginally satisfactory, examiners should regard higher incentive compensation on certain investment products and lower compensation on deposits and other investment products as having the potential for causing serious problems. In this case the compensation system itself should justify an increase in the level of bank management supervision. If supervision is not adequate, the examiner should criticize the compensation system and other objectionable factors in the setting and circumstance of the sale.

Bank supervisory employees who review and approve individual sales, accept new accounts, and review established customer accounts should not receive incentive compensation based on the profitability of individual trades or accounts that are subject to their review. Similarly, department auditors or compliance personnel should not participate in incentive compensation programs that are based directly on the success of sales efforts nor should they report to a manager who receives this type of incentive compensation. In addition, bank management should not rely on third party audit and control systems if that vendor's control personnel receive transaction-based incentive compensation.

Bank employees, including tellers, may receive a one-time nominal fee of a fixed dollar amount for each customer referred for nondeposit investment products. The payment of this referral fee should not depend on whether the referral results in a transaction.

Fiduciary Accounts

Pursuant to 12 CFR 9.11(d), examiners will review the investments held by national banks as fiduciary to determine whether such investments are in accordance with law, 12 CFR 9, and sound fiduciary principles. In so doing, they will ensure that the bank has complied with all applicable state and federal restrictions on investment transactions involving the bank's fiduciary accounts.

Under 12 CFR 9.12, national bank fiduciaries may not invest funds held as fiduciary in the stock of organizations with which there exists such a connection as may affect the exercise of the best judgment of the bank in acquiring the stock, unless there exists specific authority for such an investment in the governing instrument, local law, a court order or through consents from all beneficiaries. As to accounts subject to the Employee Retirement Income Security Act of 1974, such investments must be within the authority of that Act. These principles govern purchases of a bank's proprietary products, such as bank-advised mutual funds and private label mutual funds for fiduciary accounts.

In addition, pursuant to 12 CFR 9.11(d), examiners will determine that fiduciary purchases and retention of bank proprietary products for fiduciary accounts are in accord with sound fiduciary principles. This requires that even if specific authority exists for fiduciary accounts to purchase or retain bank-advised or bank private label mutual funds, the assets must be appropri-

ate for each account. The investment must be consistent with the purpose for which each account was created, and suitable for the beneficial interest holders of each account. This requirement exists as to purchases for individual accounts, and for conversions of collective investment funds to bank-advised mutual funds.

Twelve CFR 9.7 requires banks to conduct initial and annual reviews of each fiduciary account as well as a separate review of all securities by issuer to ensure compliance with these requirements. These reviews include:

- A documented review of each account to determine that the assets of that account, including any proprietary products, meet the investment objectives of the account. In structuring the account portfolio, the fiduciary must consider the provisions of the document establishing the account. The review must also take into account the needs of the beneficial interest holders. This review should address the issues set forth in the *Comptroller's Handbook for Fiduciary Activities*, "Portfolio Management."
- A documented annual review of all assets by issuer, including proprietary products. This review should consider the quality of fund management, fee structure, risk diversification and anticipated rates of return. It should also address the considerations set forth in the *Comptroller's Handbook for Fiduciary Activities*, "Investments."

Compliance Program

Banks must maintain compliance programs capable of verifying compliance with the guidelines specified in the Interagency Statement and with any other applicable requirements. Banks should perform nondeposit investment compliance programs independently of investment product sales and management. At a minimum, the compliance function should include a system to monitor customer complaints and to review customer accounts periodically to detect and prevent abusive practices.

Examiners reviewing the compliance operations of a bank offering a variety of retail investment products should ensure that the bank has comprehensive self-regulatory policies and that it is conducting an ongoing comparison of the bank's investment sales practices with its stated investment policy. In banks with a less elaborate investment sales program, where an internal auditing group may perform all of the bank's compliance functions, the examiner should ensure that these auditors are periodically comparing sales practices with policy.

Individuals performing the audit or compliance of the bank's investment program should be qualified and should have the necessary experience to perform the assigned tasks. Compliance personnel should also engage in ongoing training to keep abreast of emerging developments in banking and securities laws and regulations.

Banks can establish independence of audit or compliance personnel if such personnel determine the scope, frequency, and depth of their own reviews; report their findings directly to the board of directors or an appropriate committee of the board; have their performance evaluated by persons independent of the investment product sales function; and receive compensation that is not connected to the success of investment product sales.

Bank compliance programs should be modeled after those in the securities business where it is customary for compliance personnel to conduct regular and frequent customer account reviews in order to detect and prevent abuses. The extent and frequency of customer account supervision should be dictated by the aggressiveness of the sales program and the riskiness of products being offered.

Examiners should expect the bank to assign individuals independent of the sales

force to review periodically customer responses to suitability inquiries and to compare these responses to the type and volume of account activity to determine whether the activity in an account is appropriate. If account activity is unusual relative to the customer's stated objectives and risk tolerance, or if account activity is brisk relative to the size of a customer's investment or past practices, management should make follow-up inquiries to determine if the activity serves the best interests of the customer.

If examinations or routine oversight by bank management indicates that suitability problems may exist, bank management is expected to conduct its own review of all affected accounts and to institute corrective actions. If it is determined that customers may have been disadvantaged, corrective actions should be designed on a case-by-case basis and may include full explanations to customers and, where appropriate, offers to rescind trades.

Customer complaints are an indication of potential problems that warrant a prompt account review. Examiners should expect the bank to assign a bank officer who is independent of the sales force the responsibility for approving the resolution of complaints or reviewing the resolution of complaints by a third party vendor. The examiner should evaluate the system for assuring that all complaints (written and oral) receive management's attention by reviewing the bank's audit of the complaint resolution system.

Managers of high-volume investment sales programs also often use automated exception reporting systems to flag potential problems before customers complain. Such systems monitor product sales and the performance of salespersons. If the bank has such systems in place, and if the reports show significant volumes of mutual fund redemptions after short holding periods, examiners should review the steps management has taken to investigate whether the product is being sold properly.

If early redemptions are restricted to one salesperson or one branch, management can reasonably conclude that the problem is localized. However, early redemptions occurring throughout the sales network may indicate that something is wrong with the product itself or with the training provided to salespeople. Similarly, if reports indicate that a salesperson is selling one type of product almost exclusively, management may need to review that individual's performance or training.

Ultimately, the way for bank management to assure itself that the securities salespersons are providing the required disclosures and making suitable recommendations to customers is to "test" the sales program. Effective "tests" can be conducted in several ways. Larger banks sometimes employ "testers" who pose as prospective customers and test the sales presentations for a variety of issues including adherence to customer protection standards. Many other well-managed banks (of all sizes) have instituted follow-up programs to verify that their customers understood their investment transactions. A bank manager, who is independent of the sales force, may telephone customers a few days after an investment account is opened or an unusual transaction has taken place. The manager will determine if the customer understands what he or she has purchased; understands the risks, including the uninsured nature of the product; understands the bank's role in the transaction; and can generally confirm responses to a suitability inquiry previously provided.

A bank officer usually can determine if a customer understands an investment by asking the customer to describe its general features. The customer should be able to describe how the product works and its risks rather than simply recite what he or she hopes to gain from the particular investment. Managers usually also determine if the customer is satisfied with the product and service or has any problems or suggestions for improving service. If a bank institutes a telephone follow-up program, it should maintain a record of con-

versations with customers to resolve problems or disputes that may arise at a later date.

"Negative consent" letters (*e.g.*, notices informing customers that unless they object, the bank assumes the customer understands and does not object to the transactions) may be a useful element in a compliance program but should not be the sole means of verifying that customers understand nondeposit investment product transactions and the bank's role in the process.

Examiners should determine whether a bank officer has been assigned the responsibility for assuring that the bank adequately monitors the nondeposit investment accounts of customers. Examiners should also determine whether the officer has developed or is developing a system to monitor the customer account reviews of outside vendors operating bank-related sales programs.

Oversight of Third Party Vendors

When a bank uses a third party vendor to sell nondeposit investment products, the bank's board of directors must adopt a written policy addressing the scope of the activities of the third party, as well as the procedures the bank intends to use for monitoring the third party's compliance with the Interagency Statement.

To select the third party vendor and monitor the ongoing acceptability of the vendor, bank management usually reviews the vendor's experience in the business and the vendor's financial statement. Bank management also usually contacts other banks with which the vendor has done business for references. Examiners should also expect that bank management checked with the vendor's regulator before it entered into an agreement with the vendor and that management has continued to review reports furnished to the vendor by its regulator(s).

Bank management should enter into a written agreement with a third party vendor that has been approved by the bank's board of directors before the vendor is permitted to offer nondeposit investment products to the bank's customers. The agreement should outline the duties and responsibilities of each party and should include a description of all of the activities the third party is permitted to engage in on the bank's premises. The agreement also should set forth terms for the use of the bank's space, personnel, and equipment as well as compensation arrangements for personnel of the bank and the third party. The agreement also should:

- Specify that the third party will comply with all applicable laws and regulations and will act consistently with the provisions of this temporary insert, especially the provisions relating to customer disclosures,
- Authorize the bank to monitor the third party by periodically reviewing and verifying that the third party and its sales representatives are complying with its agreement with the bank, with all applicable laws and regulations, and with the provisions of this temporary insert,
- Specify the type, scope, and frequency of reports the third party is to furnish to bank management to permit bank management to fulfill its oversight responsibilities,
- Authorize the institution and the OCC to have access to appropriate records of the third party,
- Require the third party to agree to indemnify the bank for any liability that resulted from third party investment product sales program actions,
- Set forth the training which the bank expects its employees and third party personnel to possess, and
- Provide for written employment contracts between the bank and the third party vendor's employees.

Examiners will review the agreement to determine that it specifies that the third party vendor will comply with all applicable requirements contained in the Interagency Statement. Examiners also will review the

agreement to determine if it includes provisions regarding bank oversight and examiner access to appropriate records. It is expected that compliance with the agreement will be periodically monitored by the institution's senior management.

Before entering into an agreement with a third party vendor, bank management also should be satisfied that the vendor uses a product selection process similar to the one outlined below. Banks relying on a third party vendor to select products also should understand and agree with the vendor's method of analysis and document its concurrence with that method. Examiners should determine whether management has understood and concurred. Bank management should periodically investigate the vendor's product selection process to ensure that it continues to be appropriate to the bank's customer mix. Examiners also should determine whether bank management understands and agrees with contingency plans developed by the third party vendor and the product issuer to respond to customer orders during unusual surges in redemptions.

To fulfill its oversight responsibilities, it is expected that bank management will receive various reports from the third party vendor and have access to the vendor's appropriate records. The reports received will vary with the scope of the sales program and should be tailored to the needs of the institution. The reports should always include a list of all customer complaints and their resolution. Other reports that may facilitate bank management's oversight role, could include:

- A periodic listing of all new account openings and descriptions of the initial trades;
- A list of significant or unusual (for the customer) individual sales during a reporting period;
- Sales reports by product, salesperson, and location during a reporting period; and
- Reports of internal compliance reviews of customer accounts originated at the bank and reports furnished to the third party vendor by its regulator(s) on at least an annual basis.

Bank management must monitor compliance by third party vendors on an ongoing basis. Senior bank managers will be expected to ensure that specific individuals employed by the bank and by the third party vendor are responsible for each activity outlined in the bank's investment sales policy. The degree of bank management's involvement should be dictated by the types of products being offered, the volume of sales, the nature of customers' complaints, and the effectiveness of the third party vendor's customer protection systems.

Senior bank management also should appoint an officer responsible for ensuring that bank investment advertisements as well as advertisements prepared by another party that refer to the bank, or any advertisement used in bank-related sales, are accurate, not misleading, and include all required disclosures. In addition, any advertising or promotional material — prepared by or on behalf of a third party vendor — should clearly identify the company selling the nondeposit investment product and should not suggest that the depository institution is the seller.

Examiner access to the records of third party vendors should be governed by preliminary examination findings. When such findings make it clear that bank management has discharged its oversight responsibility by reviewing and responding appropriately to third party reports, only a few customer complaints have been filed against the vendor, and the vendor's reports are timely, sufficiently detailed, and prepared by someone independent of the vendor's sales force, examiner access to third party records should generally be limited to the reports furnished to management by the vendor.

Product Selection

This section describes in general terms the methods that well-managed banks use to

select specific nondeposit investment products and to determine that such products continue to be acceptable to the bank's customer mix. This information is provided to help examiners understand and review the process used by well-managed banks to make this determination.

Bank management should determine the specific laws, regulations, regulatory conditions or other limitations or requirements, including qualitative considerations, that will govern the sale of products to be offered. Although not required, most well-run bank investment sales programs limit the number of products offered so that customers and salespersons will not be presented with an overwhelming number of choices. Limitations based on product quality may also make it easier for sales managers to shield certain classes of customers from inappropriate products.

As a general practice, bank investment programs offer at least one type of money market mutual fund for customers who are interested in liquidity. In addition, most banks offer a U.S. government bond fund for customers who stress safety and steady income, an equity fund for customers interested in capital growth, and a tax-exempt bond fund for customers who wish to avoid taxes on investment earnings.

When deciding which funds to offer, managers should review the fund's performance over an extended period of time. Most bank managers prefer to avoid mutual funds with volatile records. Management's selection of a family of funds should not be based on the performance of one particular fund; each fund selection should stand on its own merits.

Management's selection of investment products usually begins with an evaluation of the stability of asset values over time and an assessment of yields to investors. Management also compares the performance of other funds with similar objectives over the same period(s). Specialized ratings services (such as Morningstar or Lipper) or rankings by analytical services are usually regarded as necessary but secondary considerations.

Management also considers the fund's track record in terms of both risk and reward. Management analyzes the fund's net asset value versus total return, its management or operating expenses, the turnover within the fund's portfolio, and capital gains and other sources of income. Other key considerations include the composition of the portfolio and concentrations in types of holdings, sector weights, and, in the case of equity funds, the percentage of ownership represented by individual issues.

Management also evaluates important nonstatistical factors such as the continuity, tenure, and demonstrated talent of the fund's management. They also may consider factors such as the quality of a mutual fund's operational and marketing support.

The bank itself, and not another entity's marketing department, should select the funds to be offered. Independent committees and qualified analysts should make the final selections, not a sales manager whose view of the commission structure may affect this judgment.

If the bank uses outside consultants to help select a mutual fund, bank management should determine whether the consultant receives compensation from mutual funds or mutual fund wholesalers. If the analysis is performed by another party, such as a clearing broker or third party vendor, bank management should understand and agree with the method of analysis and should document the bank's concurrence.

Regardless of who selects the mutual fund products, bank management will be expected to consider the issuer's contingency plans for handling unusual surges in redemptions at the time such products are being considered. Such contingency plans normally include emergency staffing, communications, and operational programs that are based on various market scenarios.

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Bank management should compare these contingency plans to the expected needs of bank customers during periods of stress.

Finally, once the initial selection process is complete, bank management should conduct ongoing reviews to assure that the products remain acceptable in light of the bank's objectives and customer's needs.

Selection of annuity products is conducted in the same manner. A variable-rate annuity, a hybrid form of investment that contains elements of mutual funds and insurance, could be characterized as a mutual fund operated by an insurance company. During product selection, bank management should consider the performance and composition of the portfolio that is dedicated to the annuity holders.

Selection analysis for fixed-rate annuities differs from variable-rate annuities. Since fixed-rate annuities are obligations of insurance companies, the risks associated with them relate to the issuer's ability to honor the terms of the annuity contract. Accordingly, the safety of an annuity depends upon the financial standing of the firm that issues it and the selection analysis involves an assessment of the quality and diversification of the company's assets, its holdings of junk bonds, mortgage-backed securities, and problem real estate loans, as well as the continuity of management.

Because it is difficult to independently analyze insurance companies, ratings provided by rating agencies such as A.M. Best, Standard & Poor's, Duff & Phelps, Moody's and Weiss Research play a part in annuity analysis. If bank management relies significantly on such ratings rather than on its own analysis, however, examiners should expect that the issuer selected by the bank has received top ratings from most of the ratings services.

When analyzing annuities, management also should recognize that an issuing insurance company can, in certain circumstances, sell or simply transfer the annuity contract to another insurance company, thereby extinguishing its obligation to the purchaser of the annuity. Annuity owners are generally, but not always, asked to consent to this transfer. A bank selling annuities should consider the possibility of such a transfer in its product selection analysis. At a minimum, the bank should disclose this possibility to prospective customers.

Interagency Statement on Retail Sales on Nondeposit Investment Products

The full text of the interagency statement begins on the next page.

Retail Nondeposit Investment Sales

Interagency Statement on Retail Sales on Nondeposit Investment Products

February 15, 1994

Introduction

Recently many insured depository institutions have expanded their activities in recommending or selling to retail customers nondeposit investment products, such as mutual funds and annuities. Many depository institutions are providing these services at the retail level, directly or through various types of arrangements with third parties.

Sales activities for nondeposit investment products should ensure that customers for these products are clearly and fully informed of the nature and risks associated with these products. In particular, where nondeposit investment products are recommended or sold to retail customers, depository institutions should ensure that customers are fully informed that the products:

- Are not insured by the FDIC;
- Are not deposits or other obligations of the institution and are not guaranteed by the institution; and,
- Are subject to investment risks, including possible loss of principal invested.

Moreover, sales activities involving these investment products should be designed to minimize the possibility of customer confusion and to safeguard the institution from liability under the applicable anti-fraud provisions of the federal securities laws, which, among other things, prohibit materially misleading or inaccurate representations in connection with the sale of securities.

The four federal banking agencies — the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision — are issuing this Statement to provide uniform guidance to depository institutions engaging in these activities.

(Note: Each of the four banking agencies has in the past issued guidelines addressing various aspects of the retail sale of nondeposit investment products. OCC Banking Circular 274 (July 19, 1993); FDIC Supervisory Statement FIL-71-93 (October 8, 1993); Federal Reserve Letters SR 93-35 (June 17, 1993), and SR 91-14 (June 6, 1991); OTS Thrift Bulletin 23-1 (September 7, 1993). This Statement is intended to consolidate and make uniform the guidance contained in the various existing statements of each of the agencies, all of which are superseded by this Statement. Some of the banking agencies have adopted additional guidelines covering the sale of certain specific types of instruments by depository institutions, *i.e.*, obligations of the institution itself or of an affiliate of the institution. These guidelines remain in effect except where clearly inapplicable.)

Scope

This Statement applies when retail recommendations or sales of nondeposit investment products are made by:

- Employees of the depository institution;
- Employees of a third party, which may or may not be affiliated with the institution (*see* Note, below, addressing which institutions are covered), occurring on the premises of the institution (including telephone sales or recommendations by employees or from the institution's premises and sales or recommendations initiated by mail from its premises); and
- Sales resulting from a referral of retail customers by the institution to a third party when the depository institution receives a benefit for the referral.

(Note: This Statement does not apply to the subsidiaries of insured state nonmember banks, which are subject to separate provisions, contained in 12 CFR 337.4, relating to securities activities. For OTS-regulated institutions that conduct sales of nondeposit investment products through a subsidiary, these guidelines apply to the subsidiary. 12 CFR 545.74 also applies to such sales. Branches and agencies of U.S.

foreign banks should follow these guidelines with respect to their nondeposit investment sales programs.)

These guidelines generally do not apply to the sale of nondeposit investment products to non-retail customers, such as sales to fiduciary accounts administered by an institution. (Note: Restrictions on a national bank's use as fiduciary of the bank's brokerage service or other entity with which the bank has a conflict of interest, including purchases of the bank's proprietary and other products, are set out in 12 CFR 9.12. Similar restrictions on transactions between funds held by a federal savings association as fiduciary and any person or organization with whom there exists an interest that might affect the best judgment of the association acting in its fiduciary capacity are set out in 12 CFR 550.10. However, as part of its fiduciary responsibility, an institution should take appropriate steps to avoid potential customer confusion when providing nondeposit investment products to the institution's fiduciary customers.)

Adoption of Policies and Procedures

Program Management. A depository institution involved in the activities described above for the sale of nondeposit investment products to its retail customers should adopt a written statement that addresses the risks associated with the sales program and contains a summary of policies and procedures outlining the features of the institution's program and addressing, at a minimum, the concerns described in this Statement. The written statement should address the scope of activities of any third party involved, as well as the procedures for monitoring compliance by third parties in accordance with the guidelines below. The scope and level of detail of the statement should appropriately reflect the level of the institution's involvement in the sale or recommendation of nondeposit investment products. The institution's statement should be adopted and reviewed periodically by its board of directors. Depository institutions are encouraged to consult with legal counsel with regard to the implementation of a nondeposit investment product sales program.

The institution's policies and procedures should include the following:

- **Compliance procedures.** The procedures for ensuring compliance with applicable laws and regulations and consistency with the provisions of this Statement.
- **Supervision of personnel involved in sales.** A designation by senior managers of specific individuals to exercise supervisory responsibility for each activity outlined in the institution's policies and procedures.
- **Types of products sold.** The criteria governing the selection and review of each type of product sold or recommended.
- **Permissible use of customer information.** The procedures for the use of information regarding the institution's customers for any purpose in connection with the retail sale of nondeposit investment products.
- **Designation of employees to sell investment products.** A description of the responsibilities of those personnel authorized to sell nondeposit investment products and of other personnel who may have contact with retail customers concerning the sales program, and a description of any appropriate and inappropriate referral activities and the training requirements and compensation arrangements for each class of personnel.

Arrangements with Third Parties. If a depository institution directly or indirectly, including through a subsidiary or service corporation, engages in activities as described above under which a third party sells or recommends nondeposit investment products, the institution should, prior to entering into the arrangement, conduct an appropriate review of the third party. The institution should have a written agreement with the third party that is approved

by the institution's board of directors. Compliance with the agreement should be periodically monitored by the institution's senior management. At a minimum, the written agreement should:

- Describe the duties and responsibilities of each party, including a description of permissible activities by the third party on the institution's premises, terms as to the use of the institution's space, personnel, and equipment, and compensation arrangements for personnel of the institution and the third party.
- Specify that the third party will comply with all applicable laws and regulations, and will act consistently with the provisions of this Statement and, in particular, with the provisions relating to customer disclosures.
- Authorize the institution to monitor the third party and periodically review and verify that the third party and its sales representatives are complying with its agreement with the institution.
- Authorize the institution and the appropriate banking agency to have access to such records of the third party as are necessary or appropriate to evaluate such compliance.
- Require the third party to indemnify the institution for potential liability resulting from actions of the third party with regard to the investment product sales program.
- Provide for written employment contracts, satisfactory to the institution, for personnel who are employees of both the institution and the third party.

General Guidelines

1. Disclosures and Advertising

The banking agencies believe that recommending or selling nondeposit investment products to retail customers should occur in a manner that assures that the products are clearly differentiated from insured deposits. Conspicuous and easy to comprehend disclosures concerning the nature of nondeposit investment products and the risk inherent in investing in these products are one of the most important ways of ensuring that the differences between nondeposit products and insured deposits are understood.

Content and Form of Disclosure. Disclosures with respect to the sale or recommendation of these products should, at a minimum, specify that the product is:

- Not insured by the FDIC;
- Not a deposit or other obligation of, or guaranteed by, the depository institution;
- Subject to investment risks, including possible loss of the principal amount invested.

The written disclosures described above should be conspicuous and presented in a clear and concise manner. Depository institutions may provide any additional disclosures that further clarify the risks involved with particular nondeposit investment products.

Timing of Disclosure. The minimum disclosures should be provided to the customer:

- Orally during any sales presentation,
- Orally when investment advice concerning nondeposit investment products is provided,
- Orally and in writing prior to or at the time an investment account is opened to purchase these products, and
- In advertisements and other promotional materials, as described below.

A statement, signed by the customer, should be obtained at the time such an account is opened, acknowledging that the customer has received and understands the disclosures. For investment accounts established prior to the issuance of these guidelines, the institution should consider obtaining such a signed statement at the time of the next transaction.

Confirmations and account statements for such products should contain at least the minimum disclosures if the confirmations or account statements contain the name or the logo of the depository institution or an affiliate. (Note: These disclosures should be made in addition to any other confirma-

tion disclosures that are required by law or regulation, *e.g.*, 12 CFR 12, 208.8(k)(3), and 344.) If a customer's periodic deposit account statement includes account information concerning the customer's nondeposit investment products, the information concerning these products should be clearly separate from the information concerning the deposit account, and should be introduced with the minimum disclosures and the identity of the entity conducting the nondeposit transaction.

Advertisements and Other Promotional Material. Advertisements and other promotional and sales material, written or otherwise, about nondeposit investment products sold to retail customers should conspicuously include at least the minimum disclosures discussed above and must not suggest or convey any inaccurate or misleading impression about the nature of the product or its lack of FDIC insurance. The minimum disclosures should also be emphasized in telemarketing contacts. Any third party advertising or promotional material should clearly identify the company selling the nondeposit investment product and should not suggest that the depository institution is the seller. If brochures, signs, or other written material contain information about both FDIC-insured deposits and nondeposit investment products, these materials should clearly segregate information about nondeposit investment products from the information about deposits.

Additional Disclosures. Where applicable, the depository institution should disclose the existence of an advisory or other material relationship between the institution or an affiliate of the institution and an investment company whose shares are sold by the institution and any material relationship between the institution and an affiliate involved in providing nondeposit investment products. In addition, where applicable, the existence of any fees, penalties, or surrender charges should be disclosed. These additional disclosures should be made prior to or at the time an investment account is opened to purchase these products.

If sales activities include any written or oral representations concerning insurance coverage provided by any entity other than the FDIC, *e.g.*, the Securities Investor Protection Corporation (SIPC), a state insurance fund, or a private insurance company, then clear and accurate written or oral explanations of the coverage must also be provided to customers when the representations concerning insurance coverage are made, in order to minimize possible confusion with FDIC insurance. Such representations should not suggest or imply that any alternative insurance coverage is the same as or similar to FDIC insurance.

Because of the possibility of customer confusion, a nondeposit investment product must not have a name that is identical to the name of the depository institution. Recommending or selling a nondeposit investment product with a name similar to that of the depository institution should only occur pursuant to a sales program designed to minimize the risk of customer confusion. The institution should take appropriate steps to assure that the issuer of the product has complied with any applicable requirements established by the Securities and Exchange Commission regarding the use of similar names.

2. Setting and Circumstances

Selling or recommending nondeposit investment products on the premises of a depository institution may give the impression that the products are FDIC-insured or are obligations of the depository institution. To minimize customer confusion with deposit products, sales or recommendations of nondeposit investment products on the premises of a depository institution should be conducted in a physical location distinct from the area where retail deposits are taken. Signs or other means should be used to distinguish the investment sales area from the retail deposit-taking area of the institution. However, in the limited situation where physical considerations prevent sales of nondeposit products from being conducted in a distinct area, the institution has a heightened responsibility to ensure appropriate measures are in place

to minimize customer confusion.

In no case, however, should tellers and other employees, while located in the routine deposit-taking area, such as the teller window, make general or specific investment recommendations regarding nondeposit investment products, qualify a customer as eligible to purchase such products, or accept orders for such products, even if unsolicited. Tellers and other employees who are not authorized to sell nondeposit investment products may refer customers to individuals who are specifically designated and trained to assist customers interested in the purchase of such products.

3. Qualifications and Training
The depository institution should ensure that its personnel who are authorized to sell nondeposit investment products or to provide investment advice with respect to such products are adequately trained with regard to the specific products being sold or recommended. Training should not be limited to sales methods, but should impart a thorough knowledge of the products involved, of applicable legal restrictions, and of customer protection requirements. If depository institution personnel sell or recommend securities, the training should be the substantive equivalent of that required for personnel qualified to sell securities as registered representatives. (Note: Savings associations are not exempt from the definitions of "broker" and "dealer" in Sections 3(a)(4) and 3(a)(5) of the Securities Exchange Act of 1934; therefore, all securities sales personnel in savings associations must be registered representatives.)

Depository institution personnel with supervisory responsibilities should receive training appropriate to that position. Training should also be provided to employees of the depository institution who have direct contact with customers to ensure a basic understanding of the institution's sales activities and the policy of limiting the involvement of employees who are not authorized to sell investment products to customer referrals. Training should be updated periodically and should occur on an ongoing basis.

Depository institutions should investigate the backgrounds of employees hired for their nondeposit investment products sales programs, including checking for possible disciplinary actions by securities and other regulators if the employees have previous investment industry experience.

4. Suitability and Sales Practices
Depository institution personnel involved in selling nondeposit investment products must adhere to fair and reasonable sales practices and be subject to effective management and compliance reviews with regard to such practices. In this regard, if depository institution personnel recommend nondeposit investment products to customers, they should have reasonable grounds for believing that the specific product recommended is suitable for the particular customer on the basis of information disclosed by the customer. Personnel should make reasonable efforts to obtain information directly from the customer regarding, at a minimum, the customer's financial and tax status, investment objectives, and other information that may be useful or reasonable in making investment recommendations to that customer. This information should be documented and updated periodically.

5. Compensation
Depository institution employees, including tellers, may receive a one-time nominal fee of a fixed dollar amount for each customer referral for nondeposit investment products. The payment of this referral fee should not depend on whether the referral results in a transaction.

Personnel who are authorized to sell nondeposit investment products may receive incentive compensation, such as commissions, for transactions entered into by customers. However, incentive compensation programs must not be structured in such a way as to result in unsuitable recommendations or sales being made to customers.

Retail Nondeposit Investment Sales
Introduction
Section 413.1

Depository institution compliance and audit personnel should not receive incentive compensation directly related to results of the nondeposit investment sales program.

6. Compliance
Depository institutions should develop and implement policies and procedures to ensure that nondeposit investment product sales activities are conducted in compliance with applicable laws and regulations, the institution's internal policies and procedures, and in a manner consistent with this Statement. Compliance procedures should identify any potential conflicts of interest and how such conflicts should be addressed. The compliance procedures should also provide for a system to monitor customer complaints and their resolution. Where applicable, compliance procedures also should call for verification that third party sales are being conducted in a manner consistent with the governing agreement with the depository institution.

The compliance function should be conducted independently of nondeposit investment product sales and management activities. Compliance personnel should determine the scope and frequency of their own review, and findings of compliance reviews should be periodically reported directly to the institution's board of directors, or to a designated committee of the board. Appropriate procedures for the nondeposit investment product programs should also be incorporated into the institution's audit program.

Supervision by Banking Agencies

The federal banking agencies will continue to review a depository institution's policies and procedures governing recommendations and sales of nondeposit investment products, as well as management's implementation and compliance with such policies and all other applicable requirements. The banking agencies will monitor compliance with the institution's policies and procedures by third parties that participate in the sale of these products. The failure of a depository institution to establish and observe appropriate policies and procedures consistent with this Statement in connection with sales activities involving nondeposit investment products will be subject to criticism and appropriate corrective action.

Questions on the Statement may be submitted to:

FRB — Division of Banking Supervision and Regulation, Securities Regulation Section, (202) 452-2781; Legal Division, (202) 452-2246.

FDIC — Office of Policy, Division of Supervision, (202) 898-6759; Regulation and Legislation Section, Legal Division (202) 898-3796.

OCC — Office of the Chief National Bank Examiner, Capital Markets Group, (202) 874-5070.

OTS — Office of Supervision Policy, (202) 906-5740; Corporate and Securities Division, (202) 906-7289.

Effective date: February 15, 1994

Retail Nondeposit Investment Sales
Examination Objectives
Section 413.2

1. To determine if the bank has taken reasonable steps to ensure that retail customers can distinguish between insured deposits and uninsured nondeposit investment products.

2. To determine if the banks' policies, procedures, and practices provide for an adequate self-regulatory system that is designed to ensure customer protections in all aspects of the sales programs.

3. To ensure that bank management operates the bank's nondeposit investment sales program in a safe and sound manner and complies with OCC guidelines, interagency statements, and all applicable laws and regulations.

4. To initiate corrective action when the bank's policies, practices, procedures, or managerial controls are deficient or when the bank has failed to comply with laws, rules, regulations or OCC guidelines.

tive supervision of the individuals engaged in sales activities - whether they are employees of the bank or of another entity involved in bank-related sales of investment products.

5. Determine how the retail nondeposit investment sales program is managed.
   a. Analyze sales program growth and earnings performance and determine why certain products have high levels of performance. Consider how this performance relates to incentive compensation and the suitability of recommendations to customers.
   b. Review the customer mix and market surveys. Look at trends in identifiable classes of customers and be alert for concentrations by types of customers. Also, try to determine whether customers are viewed as one-time buyers or are being cultivated to establish longer term relationships.
   c. Review the products offered and any market surveys and determine the risk inherent in different products. Consider whether management has attempted to match products to investors' needs in general.
   d. Review projections for the sales program and for different products and determine whether they:
      — Are realistic in light of the bank's customer mix;
      — Relate to bank staffing and training plans for the sales, supervision, and compliance functions; and
      — Are consistent with the bank's overall strategic plan.
   e. Determine the effectiveness of the bank's self-regulatory policies and procedures as measured by the number and type of customer complaints and by responses to the ICQ.

Product Selection

6. Assess the adequacy of management processes to select and review products sold. Review:
   - Responses to the Product Selection section of the ICQ.
   - Methods bank management uses to select products to meet customer needs.
   - Management's comparison of the performance of the products they offer to general market products with similar objectives.

7. Discuss your findings from the product selection review with senior management and make a judgement about the appropriateness of management's decision to continue to offer these products.

Use of Customer Information

8. Determine whether policies governing the permissible uses of bank customer information address the steps to be taken to reduce possible confusion among depositors who are being solicited to purchase nondeposit investment products.

Setting and Circumstances of Sales

9. Determine whether bank management has established effective controls to distinguish retail deposit-taking activities from retail nondeposit investment sales. Consider how the various elements of the setting and circumstances may interact to influence the customers' perception.

10. Where the deposit-taking and securities sale functions are performed by the same personnel, determine if the bank uses appropriate written and oral disclosures to guard against customer confusion, and the extent to which bank staff is trained to use, and does use, such disclosures.

Disclosures and Advertising

11. Review responses to the Disclosures and Advertising section of the ICQ and a representative sample of each type of advertising and promotional material.
    a. Determine whether all of the required disclosures are featured conspicuously in:
       — All written or oral sales presentations,
       — Advertising and promotional materials,
       — Confirmations and account statements that contain the name or the logo of the bank or an affiliate, and
       — Periodic statements that include information on both deposit and nondeposit products.
    b. Determine, where applicable, if the bank has disclosed the existence of:
       — An advisory or other relationship between the bank and any affiliate involved in providing nondeposit investment products, and
       — Any early withdrawal penalties, surrender charge penalties, and deferred sales charges.
    c. Determine whether bank-related sales advertisements are:
       — Accurate, and
       — Not likely to mislead customers about the nature of the product.
    d. Review product brochures and advertising to ensure that they do not imply that the bank stands behind an investment product. Also determine whether public statements concerning the selection of the products a bank offers are reasonable.
    e. Determine whether personnel make any written or oral representations concerning insurance coverage by any entity other than the FDIC, *e.g.*, Securities Investor Protection Corporation (SIPC); a state insurance fund; or an insurance company.

       If representations about non-FDIC insurance coverage are made, determine whether:
       — Each appropriate person who has contact with customers is trained concerning the differences among those coverages, and
       — Written or oral explanations of the differences in coverage are provided to all customers.

Suitability

12. Judge whether systems in place are adequate to ensure that sales personnel make suitable recommendations and whether management is discharging its responsibilities under these systems by reviewing:
    - Responses to the Suitability section of the ICQ,
    - Customer complaints and resolutions,
    - Sales patterns,
    - Compensation differentials that may influence recommendations, and
    - Compliance and/or audit reports.

13. If your findings in 12, above, are negative or uncertain, review a sample of sales to determine if transactions appear unsuitable for a customer, based on responses to the suitability inquiries. The sample should include transactions involving:
    - Customer complaints,
    - Marketing programs that target a class of customers,
    - First-time and risk-averse investors,
    - High or low volume salespersons,
    - More volatile and newer products, and
    - Redemptions of annuities or mutual funds after relatively short holding periods.

14. If, after the review in 13, above, you are still not certain that recommenda-

tions are suitable, direct bank management to conduct an *independent review* of all affected accounts and to report their findings to the EIC.

15. If you determine that customers may have been disadvantaged, discuss appropriate corrective action with senior management. Such action should be designed on a case by case basis and may include:
    - Full explanations to customers and, where appropriate, offers to rescind trade.
    - A recommendation to bring in an independent audit or special counsel to perform further review of customer transactions.
    - Other action agreed upon between bank management and the EIC.

Qualifications and Training

16. Assess the bank's process for ensuring that supervisory, investment sales, audit, and compliance personnel are properly qualified and adequately trained by reviewing hiring and training practices and future plans and determining whether they are:
    - Designed around the complexity and risks of the investment products being offered, and
    - Consistent with the organization's projections for growth and product line expansion.

Compensation

17. Review the compensation plan and assess the steps management has taken to ensure that compensation programs are not structured in a way that result in unsuitable recommendations or sales being made to customers.
    a. Be alert to increases in the sales volume of a particular product, to customer complaints, and to suitability problems that may relate to the incentive compensation system and/or changes in compensation.
    b. Determine whether supervision of sales programs or of individual product offerings increases as incentive compensation increases.
    c. Determine whether referral fees are, in any way, based on a sale being made.
    d. Review written performance objectives and a sample of performance appraisals for salespersons and determine if the system for motivating and rewarding salespersons strikes a reasonable balance between profitability and the need to protect customer interests.

Sales to Fiduciary Accounts

18. Determine whether, on retail nondeposit investment transactions involving the bank's fiduciary accounts, the bank has complied with all applicable state and federal restrictions, including the Employee Retirement Income Security Act of 1974.
    a. If proprietary or private label sales to trust accounts were executed through the bank's nondeposit investment sales program, determine if the transactions were expressly authorized under state law or if authorization were obtained by the bank.
    b. Determine whether management's justification of any transfer of trust account investments to investments acquired through the bank's nondeposit investment sales program has taken into account all relevant circumstances, account by account. Relevant circumstances include:
        — The provisions of the trust account,
        — The beneficiaries' needs,
        — The quality of fund management,
        — The fee structure,
        — Risk diversification, and
        — Rates of return.
    c. Determine whether the trust department conducts periodic re-

views of the ongoing prudence of the investment. Such reviews should cover:
— The quality of the holdings,
— The compatibility of investment objectives, and
— The availability of competing investments, including non-proprietary products, which might better meet the fiduciary account's investment objectives.

Compliance Program

19. Determine how effective the bank's compliance program is by reviewing:
    - Responses to the Compliance Program section of the ICQ,
    - The independence of compliance personnel,
    - Training provided to compliance personnel,
    - Automated exception reporting systems, and
    - The scope, frequency, and findings of compliance reviews, and responses to findings.

20. Determine whether results of periodic reviews are formally communicated to senior managers independent of the sales function, and whether a follow-up system tracks management responses to noted exceptions.

21. If prior examination findings, compliance reports, a pattern of customer complaints, or routine oversight by bank management identifies the possibility that suitability problems may exist, determine if bank management has conducted a thorough review of all affected accounts and instituted appropriate corrective actions.

Third Party Vendors

22. Determine the effectiveness of the bank's oversight program and whether bank management has discharged its responsibilities under the program.
    a. Review responses under the Third Party Vendor section of the ICQ and the text of the bank's oversight program.
    b. Review the scope and frequency of completed and scheduled oversight reviews and reviews of customer complaints and their resolution.
    c. Review bank management's response to recommendations made during past examinations.
    d. Review the third party vendor agreement and determine:
       — Whether it specifies that such entities will comply with all applicable requirements, including those in the Interagency Statement.
       — How bank management assures itself that third party vendors comply with the terms of the agreement.
    e. Review how bank management determined the adequacy of the steps a third party vendor takes to avoid customer confusion about the nature of the product and the bank's role in the sales process.
    f. Determine whether bank management understands and agrees with the way the third party vendor selects products.

23. After making a judgment about the effectiveness of the oversight of third party vendor sales, complete any other examination procedures that appear appropriate.

Summary

24. Determine if bank management has demonstrated by its actions whether it believes customers' interests are critical to all aspects of its nondeposit investment product sales programs.

25. Discuss significant findings with the EIC and bank management and prepare written comments.

Retail Nondeposit Investment Sales
Internal Control Questionnaire

Program Management

1. Has the bank's board of directors adopted a program management statement that addresses:
   - The features of the sales program?
   - The associated risks?
   - The roles of bank employees?
   - The roles of third party entities?

2. Do the bank's policies address the following issues:
   - Program objectives?
   - Strategies to be employed to achieve objectives?
   - Supervision of personnel involved in nondeposit investment sales programs?
   - Supervisory responsibilities of third party vendors who are selling on bank premises?
   - Selection of the products the bank will sell?
   - Permissible uses of bank customer information?
   - Communications with customers?
   - The setting and circumstances of nondeposit product sales?
   - Disclosures and advertising?
   - Suitability of recommendations?
   - Employee qualifications and training?
   - Employee compensation systems?
   - A compliance program?

3. Do written supervisory procedures assign a manager the responsibility for:
   - Reviewing and authorizing each sale?
   - Accepting each new account?
   - Reviewing and authorizing all sales- or account-related correspondence with customers?
   - Reviewing and authorizing all advertising and promotional materials prior to use?

4. Does the bank use written job descriptions to assign management responsibilities?

5. Do policies and procedures for personnel who are not directly involved in nondeposit investment product sales detail what the employees may say and not say about investment products?

Product Selection

6. Does the bank select the products to be offered?

7. If so, does the selection process make use of predetermined criteria that consider the customers' needs?

8. Does a qualified committee or an analyst who is independent of the sales function make the product selections?

9. If the bank uses outside consultants to help select products, does bank management determine if the consultant receives compensation from product issuers or wholesalers?

10. If the product selection analysis is performed by another party, such as a clearing broker or third party vendor, does bank management understand and agree with the analysis method?

11. Does the bank conduct continuing reviews of product offerings to assure that they remain acceptable and are such reviews done at least annually?

12. Does bank management consider, as part of the selection process, the product issuer's contingency plans for dealing with unusual surges in redemptions?

13. Are these contingency plans based on various market scenarios?

14. Do the contingency plans include:
    - Emergency staffing?
    - Additional communications capabilities?

- Enhanced operational support?

15. Does the analysis of fixed and variable rate annuities include a determination of the credit quality of the issuing insurance company?

16. Does the analysis of fixed and variable rate annuities include determining whether the issuing insurance company can sell or simply transfer the annuity contract to another insurance company?

Use of Customer Information

17. Do written policies concerning the use of information about bank customers address:
    - The minimum standards or criteria for identifying a customer for solicitation?
    - Acceptable calling times?
    - The number of times a customer may be called?
    - The steps to be taken to avoid confusing depositors about the nature of the products being offered?

Setting and Circumstances of Nondeposit Sales

18. Has a bank officer been assigned responsibility for reviewing all current and planned nondeposit investment sales locations to determine whether appropriate measures are in place to minimize customer confusion?

19. Are nondeposit investment products sold only at locations distinct from where deposits are accepted?

20. Are sales locations distinguished by use of:
    - Seperate desks?
    - Distinguishing partitions, railings, or planters?
    - Signs?

21. If personnel both accept deposits and sell nondeposit investment products, do operating procedures address safeguards to prevent possible customer confusion?

22. Are the people who sell nondeposit investment products distinguished from people who accept deposits by such means as:
    - Name tags or badges?
    - Business cards?

23. Do operating procedures prohibit tellers from offering investment advice, making sales recommendations, or discussing the merits of any nondeposit investment product with customers?

24. Does the bank offer nondeposit investment products with product names that are *not*:
    - Identical to the bank's name?
    - Similar to a deposit product? (Example: XYZ Money Market Fund *vs.* XYZ Money Market Account.)

25. Does the bank avoid using the words "insured," "bank," or "national" in product names?

Disclosures and Advertising

26. Has bank management designated an officer to be responsible for ensuring that bank-prepared investment advertisements and advertisements prepared by any other party are accurate and include all required disclosures?

27. Is a signed statement acknowledging disclosures obtained from each customer at the time that a retail nondeposit investment account is opened?

28. For accounts established prior to the issuance of the Interagency Statement, are procedures in place to ensure that such a signed statement is obtained prior to, or at the time of, the next transaction?

29. Is there a tracking system designed to monitor and obtain missing acknowledgments?

30. Are all salespeople provided written disclosure guidelines for oral presentations?

31. Do the guidelines for oral presentations clearly direct the speaker to:
    - State the required disclosures?
    - Clarify the bank's role in the sales process?

32. If ratings are used in promoting certain products, does bank policy indicate whether the bank will disclose ratings changes?

33. If so, does policy indicate how such disclosures will occur?

34. If the bank is selling annuities which can be transferred to another obligor, is this possibility disclosed to prospective customers?

Suitability

35. Has a bank officer been assigned responsibility for implementing and monitoring the suitability system?

36. Are systems in place to ensure that any salespeople involved in bank-related sales obtain sufficient information from customers to enable them to make a judgment about the suitability of recommendations for particular customers?

37. Do suitability inquiries include information concerning the customer's:
    - Financial and tax status?
    - Investment objectives?
    - Other information such as date of birth, employment, net worth (net of residential real estate), income, current investments, or risk tolerance?

38. Are customer responses to suitability inquiries documented on a standard form or any other method that permits ready review?

39. Is there a tracking system designed to monitor and obtain missing suitability information?

40. Are new accounts reviewed and formally accepted by a manager before the first transfer is finalized?

41. Does the new account acceptance process include a review of the suitability inquiry and customer responses?

42. Is each sale approved in writing by a designated manager?

43. Are breakpoints considered in both the initial recommendation and in the review of the suitability of those recommendations?

44. Is suitability information for active accounts updated periodically?

45. If the bank uses software programs to assist salespersons in making suitability judgments, does the program:
    - Weight bank proprietary products and bank deposits similarly to other products?
    - Consider breakpoints?

46. If a software program is *not* used, has management identified which products meet certain investment objectives, or has management generally categorized products as suitable for either unsophisticated, sophisticated, or risk-averse customers?

47. Does the bank use suitability guidelines that would limit certain transactions with first time or risk-averse investors, or would require a higher level of approval?

48. Is a bank officer who is independent of the sales force assigned responsibility for reviewing complaints and

their resolution?

Qualifications and Training

49. Does the bank's staffing plan consider its nondeposit investment sales program?

50. Does the bank seek to employ dedicated investment specialists and not platform generalists as sales representatives?

51. Does management have written qualification requirements for outside hires of salespeople and sales program managers?

52. Is a system in place to document background inquiries made about new bank sales employees who have previous securities industry experience to check for a possible disciplinary history?

53. Has a bank officer been assigned responsibility for ensuring that adequate training is provided to bank staff?

54. Does the bank have a formal training program for individuals who:
    - Make customer referrals for nondeposit products?
    - Are engaged in retail sales of nondeposit investment products?
    - Are responsible for supervising people who make referrals and/or who engage in selling?

55. Is this training offered as part of:
    - Initial training?
    - Continuing training?

56. Is there a training manual showing the objectives of each initial and subsequent training session?

57. Have lesson plans been developed for in-house programs?

58. Are tellers trained:
    - To not accept orders or sell nondeposit investment products?
    - To avoid offering investment advice?
    - To not make recommendations?
    - To not discuss the merits of any securities with customers?

59. Does the bank provide training that addresses suitability issues?

60. Does suitability training specifically address customer protection issues associated with the most vulnerable classes of investors who may actually prefer the "no investment risk" aspect of insured bank deposits?

61. Is product training provided to:
    - Compliance staff?
    - Audit staff?

62. Does the bank have a formal plan to meet future retail nondeposit investment product sales training needs?

Compensation

63. Are compensation systems set up to avoid paying the same people incentive compensation for the sale of nondeposit investment products when no incentives are paid for renewing certificates of deposit?

64. Do supervisory policies control incentive compensation increases associated with sales contests or the introduction of new products?

65. Are referral programs designed so that employees, including tellers, may receive a one-time nominal fee of a fixed dollar amount for each customer referred, without regard for whether the sale is made?

66. Do policies prohibit tellers from participating in contests or other promotional programs in which prizes are based on successful sales to customers referred?

67. Do policies and procedures preclude incentive compensation based on the profitability of individual trades by, or accounts subject to the review of, bank employees who:
    - Review and approve individual sales?
    - Accept new accounts?
    - Review established customer accounts?

68. Do policies and procedures preclude payment of incentive compensation to department auditors or compliance personnel?

69. Does the management structure preclude control, audit or compliance personnel from reporting to managers whose compensation is based on profits from nondeposit investment products sales?

70. Does the compensation program reduce remuneration to sales program managers whose accounts show:
    - Missing documents?
    - Unreported customer complaints?
    - Reversed or "bad" sales?
    - Compliance problems?

Compliance Program

71. Do audit or compliance personnel:
    - Determine the scope and frequency of their own nondeposit investment sales program reviews?
    - Report their findings directly to the board of directors or an appropriate committee of the board?
    - Have their performance evaluated by persons independent of the investment product sales function?
    - Receive compensation that in no way is connected to the success of investment product sales?
    - Receive training in products and customer protection issues?
    - Keep abreast of emerging developments in banking and securities laws and regulations through ongoing training?

72. Does the bank's written compliance program call for periodic reviews to determine compliance with policies, procedures, applicable laws and regulations, and the Interagency Statement? Do those reviews cover:
    - Customer complaints and their resolution?
    - Customer correspondence?
    - Transactions with employees and directors or their business interests?
    - All advertising and promotional materials?
    - Scripts or written guidelines for oral presentations?
    - Training materials?
    - Regular and frequent reviews of active customer accounts?
    - Customer responses to suitability inquiries and a periodic comparison of those responses to the type and volume of account activity, with the goal of determining whether the activity in an account is appropriate?

73. Does the compliance program call for compliance personnel to perform continuing reviews of:
    - Changes in the system for reporting customer complaints and resolutions?
    - Changes in previously approved standard correspondence with customers?
    - New advertising and promotional materials prior to use?
    - Changes in existing training programs or new training programs?
    - Changes in incentive compensation systems?
    - New products under development?

74. Does the timing, scope, and frequency of compliance reviews consider factors such as:
    - Changes or differences in incentive compensation paid on different or new products?
    - Sales or referral contests?
    - Patterns of sales for specific, espe-

cially new, products?
- Patterns of sales to customers who have been identified as risk-averse investors?
- New salespeople?
- Customer complaints?

75. Does the bank have a system for ensuring that all complaints (written and oral) receive bank management's attention?

76. Is that system periodically tested by internal audit to determine whether bank management receives notice of all complaints?

77. Does the bank use automated exception reporting systems to flag potential compliance problems?

78. Do reports list:
- Sales by product?
- Significant or unusual (for the customer) individual sales?
- Sales of products the bank considers more volatile to customers whose suitability inquiry responses indicate an aversion to risk?
- Customer complaints by product, salesperson, and reason, so that patterns can be discerned?
- Unusual performance by salespersons, *e.g.*, high or low volume or single product sales?
- Significant volumes of annuity or mutual fund redemptions after short holding periods?

79. Do reports provide adequate information to conduct specific suitability reviews for customers such as:
- Risk-averse investors?
- First-time investors?
- Customers with other narrow investment objectives?

80. Does the bank employ "testers" who pose as prospective customers and test the sales presentations for adherence to customer protection standards?

81. Has the bank instituted a follow-up contact program to verify whether customers understand their investment transactions?

82. Do inquiries in the follow-up contact program include discussion of the customer's:
- Understanding of what he or she has purchased?
- Understanding of the investment risks and the absence of deposit insurance coverage?
- Initial responses to the salesperson's suitability inquiry?
- Understanding of fees?
- Problems or complaints?
- Understanding of the bank's role in the transaction?

83. If the bank operates a follow-up contact program, are records of customers responses maintained?

Third Party Vendors

84. Has a bank officer been assigned responsibility for ensuring that the bank adequately monitors the effectiveness of customer protection systems?

85. Has the bank developed a written oversight program to monitor the activities of outside vendors operating bank-related sales programs?

86. Does the governing agreement with third party vendors include provisions regarding:
- Training for bank employees?
- Methods of implementing the customer protection standards contained in the bank's policy?
- Permission for the OCC and the bank to have access to appropriate records involved in bank-related sales?
- The scope and frequency of reports to be furnished?

87. Do reports furnished by third party

vendors include:
- A list of all new account openings and initial trades?
- A list of significant or unusual (for the customer) individual sales?
- A list of all written and oral customer complaints and their resolution?
- Sales reports by product, salesperson, and location?
- Internal compliance reviews of accounts originated at the bank?
- Copies of reports furnished to the third party vendor by their regulator?

88. Are reports furnished by a third party vendor:
    - Prepared by someone independent of the vendor's sales force?
    - Timely and sufficiently detailed?

89. Does bank management have procedures in place to avoid reliance on third party audit and control systems if the vendor's control personnel receive transaction-based incentive compensation?

90. If the product selection analysis is performed by another party, such as a clearing broker or third party vendor, does bank management understand and agree with the analysis method?

91. If customer information is provided to the third party vendor, has a legal opinion concerning the bank's authority to share customer information with third parties been obtained?

92. Has a bank officer been assigned responsibility for ensuring that adequate training is provided to bank staff, and for reviewing the hiring and training practices of any third party vendor?

Retail Nondeposit Investment Sales
Laws, Regulations and Rulings

	*Laws**	*Regulations+*	*Rulings+*	*OCC and Other Issuances***
Customer disclosure requirements	15 USC 77a, 78a, and 80a	17 CFR 240 (Rule 10b-5)		Interagency Statement on Retail Sales of Nondeposit Products (February 15, 1994)
Use of common names	15 USC 80a			Interagency Statement
Investments in trust accounts	29 USC 1001 (ERISA)	9		Interagency Statement
Recordkeeping and confirmation requirements for securities transactions		12		Interagency Statement
Antifraud restrictions	15 USC 77a and 78a	17 CFR 240 (Rule 10b-5)		
Uniform guidelines				AL 93-11 and Interagency Statement
Customer protection rules	15 USC 77a, 78a, and 80a	17 CFR 240 (Rule 10b-5)		NASD Rules of Fair Practice and Interagency Statement

* 12 USC unless specifically stated otherwise
\+ 12 CFR unless specifically stated otherwise
** BC = Banking Circular, EC = Examining Circular, AL = Advisory Letter

RETAIL SALES OF NONDEPOSIT INVESTMENT PRODUCTS

QUESTIONS AND ANSWERS

SCOPE

Q.1. Does the statement apply to the sale of repurchase agreements?

The guidelines apply to the retail sale of all nondeposit investments, including repurchase agreements, to bank customers. Nothing in the guidelines would apply to nonretail sales such as institutional sales.

Q.2. If a bank offers discount brokerage services, do the guidelines apply?

The guidelines apply to the bank's discount brokerage services; however, certain provisions such as suitability determinations may not apply if the bank gives no investment advice.

Q.3. Do the guidelines apply to the bank sale of life insurance products?

The guidelines apply only to the extent a particular life insurance product has an investment component. For example, term life insurance has no investment component so it would not be covered by the guidance. However, in recent years some life insurance products have been marketed as investments. To the extent that life insurance policies sold by the bank have an investment component, the guidelines apply. Some aspects, such as the disclosures, may need to be reviewed to reflect differences in the products.

Q.4. Do the guidelines apply to the sale of savings bank life insurance?

The FDIC regulations sections 362.3(b)(3) and 362.4(c)(1) relate to the sale of savings bank life insurance. The disclosure requirements of the guidance do not apply to the sale of savings bank life insurance products; however, other parts of the guidelines may be applied when appropriate.

Q.5. If the bank offers real estate brokerage services, do the guidelines apply?

Although real estate sales may be considered to be a nondeposit investment, it is doubtful that customers would be confused about FDIC insurance coverage of a real estate investment. Therefore, the guidelines do not apply to bank real estate brokerage activity.

Q.6. If the bank is a registered municipal securities dealer or a or U.S. Government securities dealer, do the guidelines apply?

Municipal securities dealers and U.S. Government securities dealers are separately registered and subject to a separate supervisory scheme. These activities are not covered by the guidelines.

Q.7. If the bank is directing retail sales of nondeposit investment obligations through its trust department, do the guidelines apply?

A review of these activities will have to be made on a case-by-case basis. The exception that the guidelines do not apply to bank fiduciary activities was designed to cover traditional trust activities. However, many banks are directing their retail sales of nondeposit products through the trust department. Therefore, the guidelines would apply to individual accounts administered in an agency capacity by the bank which were set up solely to facilitate the purchase of nondeposit investment products.

DISCLOSURES AND ADVERTISING

Q.8. Must the disclosures a bank gives its customers be worded in an exactly stated manner?

The disclosures contained in the guidelines are the minimum information to be given. Disclosures that contain other information are acceptable, as long as that information does not distract from the core disclosures. Wording of the disclosures may vary in order to more accurately reflect a particular product, so long as the basic intent of the disclosures is not changed.

Q.9. The guidelines indicate that written disclosures should be conspicuous and presented in a clear and concise manner. How do we define clear, concise and conspicuous?

The Division of Supervision expects that examiners will use their best judgment in making a determination if disclosures meet these tests; however, there are certain standards which should be met. Clear, concise and conspicuous in connection with written disclosures should be interpreted to mean that the disclosures are different in some fashion from other surrounding text, are readable and are presented in a manner that is easily understood. Bold print, different color print, larger print, highlighting, or other reasonable methods of distinguishing the disclosures are methods of making the disclosures conspicuous. Disclosures on a back page, in the middle of a brochure or in a footnote will generally not be considered to be conspicuous.

Oral disclosures should be made in a manner such that the customer can understand what is being said. If a bank has a significant customer base for whom English is not the primary language, the bank should consider making disclosures in the customers' primary language.

Q.10. Must the disclosures be made on all types of advertising?

It is not practical to make all or, in some cases, any of the disclosures on certain types of advertising. Sections 328.3(c)(2)(3)(4)(5)(8)(9)&(10) of the FDIC's regulations provide exemptions to the official deposit insurance advertising statement which are also examples of when it would be reasonable to make exemptions to the recommended disclosures contained in the guidelines.

Q.11. What is a sales presentation for purposes of understanding when oral disclosures must be made?

The bank has made a sales presentation when specific products are being discussed. Therefore, general sales pitches such as "visit our investment center" would not require that oral disclosures be made.

SETTING AND CIRCUMSTANCES

Q.12. The guidelines indicate that sales or recommendations of nondeposit investment products should be conducted in a physical location distinct from the area where retail deposits are taken. What is meant by "distinct"?

The nondeposit investment product sales area can be made distinct in many different ways. The most obvious and probably the best way is to physically separate the area with walls and doors. However, in some circumstances this is not practical. In these cases, the bank can achieve physical distinction by using such things as dividers, signs, furniture, etc. to set apart the investment area from the deposit taking area and clearly identify the investment area as such. Because achieving physical distinction can be handled in a number of ways, it is expected that in most cases banks will be able to comply with the guidelines.

QUALIFICATIONS AND TRAINING

Q.13. If a person involved in the bank's sales program of nondeposit investment products has been subject to disciplinary actions by securities or other regulators, may that person continue to work in the bank?

Section 19 of the Federal Deposit Insurance Act does not apply to that person's employment; however, it is the FDIC's responsibility to investigate the circumstances of the disciplinary action. If the action would prevent the person from continuing as a registered or licensed agent, the person's employment in the bank, especially in the sale of nondeposit investment products, would be subject to criticism.

Q.14. Are bank employees eligible to be registered securities broker/dealers?

The NASD does not currently offer securities broker/dealer training or licensing to persons who are not employees of a registered broker/dealer. If the bank contracts with a third party vendor which is a registered broker/dealer bank employees may become "dual employees" and be employees of the broker/dealer for the purpose of securities sales. In such cases, they can receive NASD training and licensing. Similar training may be available elsewhere and may be offered in the future through bank trade associations. Acting Chairman Hove recently testified before a subcommittee of the House Banking Committee that the FDIC believes all persons selling mutual funds should be subject to the same training and examinations requirements, whether they work for a bank or not. He added that the FDIC will be exploring with the SEC, NASD, and other banking regulators how that can be accomplished.

SUITABILITY AND SALES PRACTICES

Q.15. What documentation must the bank maintain if a customer refuses to give the investment advisor information necessary to make a suitability determination?

The customer's file should contain a signed statement from the customer that certain information requested has not been given to the bank. The bank should make recommendations consistent with the information given and the type of investments the customer has requested. Suitability determinations do not come into play when a customer specifically requests a particular investment product and no recommendations are made.

Q.16. Should the sales person be required to describe a product to a customer, even though the customer has requested the product, to make sure the customer is aware of what he/she is buying?

Suitability determinations are necessary only when the bank is offering investment advice. If the customer specifically requests a particular investment product, the bank may sell that product without elaboration based on that customer's request. However, it is always a prudent sales procedure for a sales person to make sure the customer knows what kind of product he or she is buying.

COMPENSATION

Q.17. Products such as securities and insurance are commonly marketed with the sales person receiving a commission for the sale of the product. Persons involved in taking bank deposits commonly do not receive sales commission compensation. Is there an inherent conflict of interest in a bank marketing both types of products?

Persons who are involved with selling products with sales commissions are not likely to have the same enthusiasm for selling a product which has no sales commission. The FDIC believes that if a bank allows its employees to receive commissions for selling an investment product, it should consider commissions for the sale of a bank product. Otherwise, commissions should flow to bank income and be distributed through salaries or other compensation that is not directly connected with the sale of nondeposit investment products.

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